104

REVIEW OF THE SBIC AND SSBIC PROGRAMS

ARING

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COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

WASHINGTON DC, MARCH 28, 1995

Printed for the use of the Committee on Small Business

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CONTENTS

WITNESSES

Tuesday, March 28, 1995

APPENDIX

REVIEW OF THE SBIC AND SSBIC PROGRAMS

TUESDAY, MARCH 28, 1995.

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m. in room 2154 Rayburn House Office Building, the Honorable Jan Meyers (chairwoman of the committee) presiding.

Chairwoman MEYERS. The committee will come to order. Today the committee will be hearing testimony concerning the Small Business Administration's Small Business Investment Company Program.

Founded by the Small Business Investment Act of 1958, SBIC's are venture capital companies that use private funds supplemented with Government leverage to provide financing for small businesses. The program was created as a response to a Federal Reserve report which identified a lack of long-term financing for the small business sector.

In 1972, the program was expanded with the creation of the Section 301(d) Specialized Small Business Investment Companies. The SSBIC's were established specifically to help provide financing to businesses owned by socially or economically disadvantaged persons who had difficulties participating in the economic mainstream.

Today SBIC's and SSBIC's represent $4 billion in a total venture capital industry that has over $37 billion in assets under management. This is in contrast to 1978, when the entire venture capital industry was only $3.5 billion.

However, the SBIC industry has not been free of problems. Over the years, a series of well-publicized failures and overall difficulties have led to changes in the program.

In 1991, Congress created the Participating Securities Program, designed to provide patient capital for the SBIC's and cure a mismatch between financing and investments. In addition, management changes were implemented, transferring auditing functions from the Inspector General's Office back to the Investment Division.

Despite these efforts, problems continued to appear in the SBIC and SSBIC Programs. One hundred and ninety-two SBIC's and SSBIC's are in liquidation, and there is roughly $523 million of Government leverage at risk. Last year, the committee received a GAO report documenting the misuse of an SSBIC in Arkansas by wealthy individuals connected to the White House.

Today's hearing will investigate the administration's program in overcoming these problems and the current state of the SBIC and SSBIC Programs.

I have got to say I was very distressed with some of the testimony that I have read previous to this morning's hearing. It seems to me like 192 SBIC's and SSBIC's is an enormously large number of this program to have in trouble. Seven hundred and ninety million dollars is lost, of which we expect to recover slightly over one half. The SSBIC's can provide a loan or equity capital to someone just because they are a minority, regardless of economic need, and yet they get financial incentives to make these loans.

I think we are going to have to do a lot of work on this program. Some of the testimony I read said that some of these firms have been in liquidation for 20 years.

I would, at this time, recognize the ranking member of the committee, Mr. LaFalce.

Mr. LaFalce. Thank you very much, Madam Chair. I am particularly pleased that you have convened a hearing on the SBIC Program. I think that it is one that has significant potential, but also one that requires constant and vigilant scrutiny.

Our committee has expended considerable effort in past years in an attempt to make the SBIC Programs true public-private partnerships which provide needed venture capital to small business, on the one hand, while appropriately safeguarding the agency's investment, on the other. Sometimes that is a difficult balance to find.

Both the SBIC and, of course, the Specialized Small Business Investment Company Program were established long before the chair and I came to Congress, but by the 1980's they clearly had fallen on very difficult times. The number of companies licensed by the SBA had declined 50 percent, with some companies voluntarily turning in their licenses and others being terminated by SBA, put into liquidation by SBA.

Our committee attempted to respond by closely examining the problems of the SBIC industry. We came to the same conclusion that many industry experts came to: The Government, by its program, was effectively squeezing the equity-oriented part of the industry to death, eliminating any incentive for private sector participation. The Government insisted that the industry make equity investments which would provide, by definition, no income for the SBIC investor for 4 or 5 years until the small business being financed could develop its business.

On the other hand, there was still a Government requirement that the SBIC pay interest on its borrowings through the SBA. So those were conflicting demands. In an effort to comply with those conflicting demands, the SBIC had no choice but to cannibalize itself and use its private capital to make interest payments.

As a result, many SBIC's slowly, and in some instances though, quickly became insolvent. The result was that everyone lost. Private investors lost their investment and SBA lost due to claims against its guarantee.

We could have just eliminated the program, but that was not the disposition of the Bush administration, nor of the Congress. The Bush administration, especially under the leadership of Adminis-

trator Saiki, said we should preserve this program and correct it. We attempted to work with Mrs. Saiki in order to do that and so we sponsored the law in 1992 the administration proposed, the Small Business Equity Enhancement Act.

Under that bipartisan legislation, the Government agreed to advance interest payments due from the SBIC to private investors until the SBIC realizes profits on its investments and the Government shares in the profits the SBIC earns. This is the concept known as a participating security.

The reaction of the private sector to this important change has been rather dramatic. SBA only finalized its implementing regulations the middle of fiscal year 1994. Shortly thereafter, the agency received a flood of license applications. During fiscal year 1994, the agency licensed 35 new SBIC's who have $493 million in private capital, or slightly more than $14 million per firm. This trend has continued this year with SBA licensing 8 more firms with average private capital of $23 million.

At the same time, it has returned or denied license applications. In the past 18 months it denied applications from 28 companies who would have offered aggregate private capital of $348 million. So the acceptances have not been arbitrary and capricious or willy nilly. They have turned down $348 million in private capital from 28 companies.

Of course, licensing companies is not what the program is all about. Its purpose is to provide venture capital to small business concerns. In this regard, I should note that the combined SBIC-SSBIC Programs provided $1 billion in venture financing through fiscal year 1994.

Now, all, every person, Democrat or Republican, liberal or conservative, hope that the bipartisan '92 legislation put the SBIC industry on the road to viability and that the Nation's small businesses are on the road to getting the venture capital they sorely need.

On the other hand, there is no question that the specialized, or SSBIC industry, continues to have its problems. Last year the number of licensees declined by 10 percent from the '93 level.

It would seem clear that we need input from another blue ribbon commission similar to the Cloherty Commission which examined the SBIC Program 4 years ago. SBA has agreed to this proposal. It is my understanding that the agency should receive a report by early summer.

Further, it is also quite clear that as a result of the GAO scrutiny pursuant to letters that I sent last year asking the GAO to investigate and that Chairperson Meyers sent also, that there are still difficulties in the SBIC Program.

One of the things we want to determine, are these difficulties basically the difficulties that existed prior to 1992 and that continued today because it is going to take time to work these companies out of liquidation, or have there been an avalanche of new difficulties circa 1993 or 1994, and what were the cause of those difficulties then? Did they pre-date? It is important to understand the timing of this, the sequence of this, in determining the remedial legislation.

Also, we need to understand what is going on in the agency. In the desire to license new applicants, have we transferred personnel from an oversight mission and responsibility to a licensing and, therefore, have we been remiss in oversight?

It is one thing to say that we will do more with less. It sounds good. But, usually, you do less with less. Let's not kid ourselves. That's one of the concerns I have about yesterday's recommendations. I know you will have to put the best face on it you possibly can, but less is not always better. Sometimes less means, of necessity, worse.

Of course, it is very important that we continue to give close scrutiny to this program considering the potential, the upside, but also the potential downside. I have no doubt that, under the leadership of the Chairman Meyers, this program will continue to have very tough oversight, as it should.

I thank the chair for doing that. Thank you.

Chairwoman MEYERS. Thank you, Mr. LaFalce. Without objection, all Members will have the opportunity to enter opening statements and submit written testimony.

Our first witness is Mrs. Mary Jean Ryan, Associate Deputy Administrator for Economic Development at the Small Business Administration. Mrs. Ryan is accompanied by Mr. Robert Stillman, Associate Administrator of the Investment Division at the SBA. I don't know why Mr. Stillman is not doing our testimony this morning since he is in charge of the program but, Ms. Ryan, I will recognize you.

TESTIMONY OF MARY JEAN RYAN, ASSOCIATE DEPUTY ADMINISTRATOR FOR ECONOMIC DEVELOPMENT, SMALL BUSINESS ADMINISTRATION; ACCOMPANIED BY ROBERT STILLMAN, ASSOCIATE ADMINISTRATOR, INVESTMENT DIVISION, SMALL BUSINESS ADMINISTRATION

Ms. RYAN. Thank you. I would like to request that my full written statement be submitted for the record.

Chairwoman MEYERS. Without objection.

Ms. RYAN. As you know, yesterday the President announced a dramatic restructuring proposal for SBA and, as part of it, he directed SBA to study the concept of privatizing the SBIC Program. He asked for a recommendation on that within the next 30 days. This review will also look for additional ways to improve the program and to further decrease the program's costs.

The SBIC Program increases the availability of equity capital and long-term debt. It fills a gap that the other SBA loan programs don't address.

As you pointed out, accompanying me today is Bob Stillman, the head of the program. As you know, Bob is a very highly respected veteran of the venture capital industry. When the SBIC Program began in 1958, he was associated with Payson & Trask, one of the earliest organized venturing firms. Marty Teckler, SBA's Deputy General Counsel is also joining us today.

Because this is a very technical program and there are a lot of issues, at your request we would be happy to meet with you again at your convenience to go into more detail if time doesn't permit all the questions to get answered today.

Let's talk first about why firms need this type of financing and why the standard debt products don't work for this band of firms. This type of financing is needed by young companies with significant growth potential which need more equity than the owners can supply or more debt than a bank can lend.

Often, these firms face very large startup costs and face an extended period of time before the company can begin to be profitable. The Congress created this program because private investors and banks do not adequately provide the patient capital required by these firms.

The Government also steps in because the economic development impact of assisting this segment of the small business market is enormous. To illustrate this, let's use a real life example. I think there was a story in the paper about this company today, actually.

In 1985, three SBIC's invested $862,000 in a computer services company to fund its startup expenses. This included funding equipment and working capital to pay for the technical expertise that the company needed.

In time, this company grew and it went public. Today the company, which is called America On-Line, is the fastest growing company in the field of computer data access. Last year, sales revenues were approximately $144 million and the company paid $5 million in taxes.

Most private venture capital firms are unwilling to make investments of less than several million dollars each. In 1994, the industry average investment size was $3 to $4 million dollars per company. SBIC's are limited by statute and regulation to invest only in small companies. In 1994, the average investment for SBIC's was $750,000 and for SSBIC's it was $110,000.

Furthermore, SBA gives highest priority to license applications from parts of the country which are underserved by venture capital and to those which will finance new businesses. Banks, as we have talked about in some of the prior hearings, prefer to make shorter term loans. In addition to the straight equity which many of the SBIC's provide, they can also provide a form of debt which is long term and which takes more risk than the level of risk a bank regulator would allow.

Before we go into more of the details, I would like to just take a minute and walk through the mechanics of how the program works. The program is funded primarily through the private market. A venture capitalist will start with the SBIC on the chart. A venture capitalist raises capital to create an SBIC and, as has been mentioned, the average capitalization today is much higher than it was in previous times. It is approximately $15 million.

A new requirement also is that 30 percent of the private capital that the SBIC raises must come from investors that are unrelated to the SBIC's management. We think that will also be a major strengthening point for the new program.

All of this money, it's important to realize, is taking more risk than the Government's money. You can see our little microscope on the chart. The SBIC analyzes proposals from businesses that are seeking growth capital and it identifies good candidates. Then the SBIC issues either a participating security or a debenture, which SBA guarantees and which is sold to private investors.

The funds from the private investors then flow back through to the SBIC, and the SBIC, along with its own money, usually in a ratio of about two to one, then invests either as equity or subordinated debt in the small business.

All of this flow of funds is made possible at a cost to the U.S. Government of approximately $11 for every $100 of the guaranteed leverage. Eleven per hundred is the average subsidy cost of the SBIC financing vehicles.

We have talked a lot in the prior hearings about the many, many misperceptions about the SBA of old, and perhaps the SBIC Program is the best example of how SBA has changed, and especially has changed over just the last couple years.

Just a couple of the highlights I want to mention. The amount of financing that is being provided to small businesses has gone up dramatically. This is probably the most astounding statistic in terms of the private dollars that are now at risk and at work in this program. In a 2-year period it has gone from $24 million to $520 million.

The size of the SBIC's is significantly larger. Again, we believe this will really help strengthen the program. The private dollars at risk used to be an average of 2.4 million and now the initial capitalization is coming in at 15 million.

The cost to the taxpayer for the larger program has increased, but we think it is a relatively modest increase relative to the amount of private capital that has been brought to the table and relative to the amount of increased financing for small business.

Another major improvement to the program which has been previously mentioned has been the introduction of the new financing instrument which is structured properly now to provide patient capital, and that is the participating security.

A couple points that aren't on here which I just want to mention briefly is the importance of good management, and that is a real emphasis in the new program. The licensing unit pays a lot of attention, probably more now than to any other single factor; they watch for and license only groups that have experienced venture capitalists who know how to make these investments.

The other major program improvement has come with the examination function. We are now examining the SBIC's every 14 months, and that is an improvement over where we were 2 years ago when we were only examining every 22 months.

You should know that our direction, Bob Stillman's direction, to the examiners is to raise all concerns and to err on the side of raising small concerns, so that the program management knows everything that is going on in the program. We feel very strongly that we have to reestablish the credibility of the program and insure the program's integrity.

A final chart shows very dramatically the increase in the private sector's dollars that have been brought into the program. I think you can see that graphically and just the real change in the relationship between the private dollars and the Government's dollars. We think the relationship is moving dramatically in the right direction.

Finally, this program is a real economic development program. It has a real orientation for economic development in the investments

that the SBIC's make. Forty-four percent are going to manufacturers and 22 percent of the whole are going to high technolgy businesses.

I would now like to touch briefly on the specialized SBIC Program. This program is different from the SBIC Program because it provides equity and long-term loans to businesses owned and controlled by persons who are socially or economically disadvantaged. The SSBIC Program is the only Federal Program dedicated to this mission and it is an important component of SBA's full range of support to disadvantaged businesses.

In order to encourage investment in SSBIC's by private investors, the law directs SBA to provide lower capital costs to the SSBIC's than for regular SBIC's. This is done in several ways: Through subsidized debentures, 4 percent preferred stock, and by the provision of additional leverage.

Over the years the SSBIC's have financed over 17,000 small businesses. We have established an SSBIC advisory council to examine the program and to suggest improvements to us to better serve this market. This council will give us its recommendations in June.

Your letter of invitation asks for a brief update on the participating securities. In April of 1994, SBA published the regulations implementing the provisions of the Small Business Equity and Enhancement Act of 1992. A total of 24 SBIC's have been licensed now to use the participating security, having private capital of $386 million, or an average of $16 million each.

On February 22nd we had the first private market funding for participating securities. While we are still at the very beginning stages of implementing the participating security, we remain very optimistic that its usage will be an important part of an increasingly successful SBIC Program.

Now let's look at the program's cost, the historical losses, and its tax generation track record. The fiscal year 1995 appropriation of $46.4 million will provide $370 million in leverage. For fiscal year 1996 the budget request is $57.2 million to provide $452 million in leverage.

The SBIC and SSBIC Programs are administered with 61 employees in Washington and 30 examiners located around the country. The administrative cost is approximately $6 million. This year we expect the program to generate about $3 million in fees.

These appropriations will be more than recovered in taxes paid by SBIC's, SSBIC's, and the small companies in which they invest. An independent council has estimated that the SBIC investments have created more than a million new jobs.

Even the losses of the flawed program of the past have been recovered indirectly through tax revenues. During the 35-year history of this program a total of $3.4 billion of leverage has been provided or guaranteed by SBA; $231 million has been written off, another $253 million of losses are anticipated from companies that are currently in liquidation.

Chairwoman MEYERS. Could you make that last statement again?

Ms. RYAN. Sure. In the history of the program, $231 million have been written off, and from the SBIC's that are in liquidation right

now our projection is that we will write off an additional $253 million.

These total losses for the history of the program have been more than offset by the approximately $568 million in taxes that have been paid by SBIC's and SSBIC's since 1976. This is a pretty amazing statistic because we are not including taxes paid or any estimates of taxes paid by the actual small business that SBIC's have invested in, simply the taxes paid by the SBIC's.

But, very importantly, we are not at all raising this to say that the past level of losses is acceptable or that we expect it to continue. We are simply pointing out that this really is an investment program and that the tax and job generation potential should not be overlooked when we examine the financial performance of this program.

That concludes my remarks, and we'll be glad to answer all questions.

[Ms. Ryan's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much. We will come back to you for questions, Ms. Ryan.

Our next witness is Mr. Jim Wells, Associate Director of Housing and Community Development Issues at the General Accounting Office. Mr. Wells will be reporting to us on the GAO's findings regarding the SBIC Program.

TESTIMONY OF JIM WELLS, ASSOCIATE DIRECTOR OF HOUSING AND COMMUNITY DEVELOPMENT ISSUES, GENERAL ACCOUNTING OFFICE

Mr. WELLS. Thank you, Mrs. Chairman and members of the committee. We are pleased to be here today to discuss the Small Business Investment Company Programs. Over the years, as you are well aware, GAO has reported on a number of problems with the eligibility and prohibitive financial transactions that have occurred in these programs.

Madam Chairman, you asked us earlier this year to begin a comprehensive assessment of the investment programs and, as Mr. LaFalce mentioned earlier in his statement, we have ongoing continuing work for him also.

At your request, our testimony today, which is based on this ongoing work and our preliminary findings, will focus on SBA's oversight, examinations, licensing, and liquidation areas. Just briefly, I will touch on each of these areas.

You asked about the prohibitive business practices that have occurred at some of the investment companies. Last year, as you mentioned, our Office of Special Investigations had reported on a SSBIC that engaged in prohibitive transactions, including giving loans to owners of business associates, making loans for purchasing real estate, and providing loans to business ventures owned by individuals with questionable eligibility

For this hearing we asked SBA examiners to identify for us from their own reports examples of prohibited practices. We looked at 111 regulatory violations and misconducts that they identified. My full statement highlights quite a few of those, but let me just mention two examples.

The president of one SBIC and his family charged over $200,000 in personal expenditures to the SBIC's travel and entertainment account. The SBIC is currently in liquidation and SBA expects to lose $2.2 million.

Another SSBIC made a $260,000 loan to a liquor store owner, part of which was used to purchase a $250,000 home. This SSBIC is also in liquidation and SBA expects to lose $1.6 million.

At least 20 investment companies or their portfolio companies, are currently being investigated by the SBA Inspector General or the Department of Justice for criminal misconduct, including food stamp fraud and money laundering.

In large part, these prohibited practices have occurred because of problems in the programs' oversight and licensing. Within SBA's Investment Division, the Offices of Operations and Examinations are currently responsible for overseeing these types of programs and performing examinations.

In Fiscal Year '94 alone, over 500 regulatory violations were reported and 220 reports issued by Investment Division examiners. I need to make this clear. While we found no indication of efforts to restrict or influence these examinations, the current organizational placement of the Office of Examinations within the Investment Division may create a question about its independence.

For example, the Associate Administrator for Investment is also responsible for all program aspects, including the licensing and the monitoring of the programs. As head of that division, the Administrator is the advocate for the programs both internally to SBA and externally, to the small business investment communities. We raise this as a red flag. Not that we saw anything, but in the future one would need to watch that.

For instance, over the 12-month period ending on February 28, 1995, we noted that 136 reported violations were still unresolved from previous examinations. For example, two earlier examination reports cited an SBIC for failing to maintain adequate controls over portfolio evaluations. As a result, this SBIC may have materially overstated the value of its portfolio and therefore failed to notify SBA of its regulatory capital impairment.

In another instance, an SSBIC had an outstanding violation for making a loan to a former board member to pay personal income tax within 6 months of the member's resignation. This same SSBIC in consecutive examinations was cited for providing financing to a business owner who are not a member of a disadvantaged group.

Madam Chairman, you also asked us about the status of licensing procedures. The procedures used by SBA to license an SBIC or SSBIC before 1994 focused, quite frankly, little attention on the background and expertise of the prospective licensees. History has shown us that these programs have encountered a number of abuses, some of which we mentioned earlier.

However, SBA's April '94 new licensing procedures are encouraging admission to the SBIC program for more highly capitalized and experienced applicants. For example, we looked at the 37 applicants that were licensed under the new procedures since April and we agree with Mary Jean Ryan that the average of these new licensees in terms of private capital $16.1 million, as compared to an earlier average of $4.8 million at the beginning of fiscal year '94.

While from an audit perspective it may be too early for us to tell for certain whether these changes will have a major impact, certainly these changes are intended to create a more financially stable class of investment companies and potentially reduce SBA's future losses.

You also asked about liquidation and receivership recoveries. Since 1966, 584 investment companies with funding of approximately $1.2 billion owed to SBA have been transferred to the Office of Liquidations. Of the 192 investment companies currently in liquidation which you referred to owing $790 million, SBA projects that it will be able to recover about 56 cents on the dollar. In contrast, SBA recovered 70 cents on the dollar in prior years from completed liquidations.

Just turning quickly now to some of the liquidations that have ended up in court receivership, at the end of 1994, 71 investment companies with $264 million in funding from SBA were in receivership. This receivership process can be lengthy, costly, and in some cases, not financially beneficial. For example, 23 investment companies have been in receiverships for 5 or more years; two have been in receiverships for over 25 years.

One SBIC we reviewed was placed in receivership in 1984 to recover an SBA investment of approximately $7.8 million. The final receivership report submitted to the court 9 years later in 1993, showed that most of the assets were worthless or uncollectible, and that the cost of collection exceeded the little over $100,000 that was actually collected.

I guess you can say that SBA probably guessed wrong in pursuing these particular receivership cases, but it does highlight the difficulties that face SBA in terms of not knowing a lot about the portfolio companies that the SBIC's invest in.

Madam Chairman, that is a quick summary. I see my red light is on. I need to say that we, as auditors, tend to look for problems. On SBA's behalf, good things have happened in these programs. SBA states, as they mentioned in their testimony, that over the years they have helped or been involved with 75,000 small business companies and they point to a number of their success stories.

I think the new licensing procedures that they implemented in April are responding to many of the criticisms that have occurred in the past, and indications are that they are, in fact, getting better experienced, more highly capitalized applicants.

SBA officials indicated to us that these front end changes will go a long way towards ultimately helping the program in the future in terms of reducing losses.

From my perspective, as we continue our ongoing work for you, these changes are relatively new and it is difficult for us to measure their impact today.

This concludes my prepared remarks. We at the GAO will be continuing to work with you in looking at these SBA Programs. We will be pleased to respond to questions.

Chairwoman MEYERS. I realize your red light is on; however I would like you to summarize your testimony about the 3 percent stock buyback program briefly.

Mr. WELLS. I would be glad to. You had basically asked us to look at the 3 percent preferred buyback program. Our work is con-

tinuing and we are prepared this morning to give you a status report of what has occurred in that program as of today. As you are well aware, the Congress has authorized this program which allows SSBIC's to repurchase their stock from SBA.

We determined that 15 SSBIC's have participated in this program, and they have repurchased $41 million, which is par value, in preferred stock from SBA for a value of $14 million.

We are continuing our work and we will look forward to giving you additional details as our work continues.

Chairwoman MEYERS. A part of the program that was not authorized by the Small Business Committee, but by another committee. Are you concerned about that? As of January, 1995, 15 SSBIC's had purchased $41 million in 3 percent preferred stock from SBA for $14 million.

Mr. WELLS. That's correct.

Chairwoman MEYERS. In addition, the 15 SSBIC's were forgiven $14 million in accumulated dividends.

Mr. WELLS. Accumulated dividends. That's correct. That is the current status. There are additional applications being considered.

Mr. LAFALCE. I believe, Madam Chair, that was the Ways and Means Committee you were referring to.

Chairwoman MEYERS. I think it was Appropriations Committee. It was not—it certainly was not this committee, however.

Thank you very much, Mr. Wells.

[Mr. Wells' statement may be found in the appendix.]

Chairwoman MEYERS. Our next witness is Dr. James Hoobler, the Inspector General of the Small Business Administration. Dr. Hoobler has been the Inspector General since 1991. He will be giving us his view of some of the management improvements and failings in the SBIC Program.

TESTIMONY OF JAMES HOOBLER, INSPECTOR GENERAL, SMALL BUSINESS ADMINISTRATION

Mr. HOOBLER. Good morning, Madam Chairman and members of the Small Business Committee. Thank you for inviting me to discuss the Small Business Investment Company and the Specialized Small Business Company Programs.

First, I would like to introduce my colleagues who are with me today. At the far end of the row is Peter McClintock, Assistant Inspector General for Auditing; next to Pete is Steve Marica, Assistant Inspector General for Investigations; and, last but certainly not least, Tim Cross, Assistant Inspector General for Inspection and Evaluation.

Before I summarize the related work for the Office of Inspector General, I would like to request that my full statement be submitted for the record, and I will do my best here this morning to summarize.

Chairwoman MEYERS. Without objection.

Mr. HOOBLER. I would like to make clear that my comments this morning are largely directed to the operations of these two venture capital programs prior to the agency's promulgation of new regulations last spring. While addressing the extent of our oversight activities relevant to these two programs, I will also cover most, if not all, the questions posed in your March 22nd letter of invitation.

I would like to turn first to investigations. During the past 3 fiscal years, the Investigations Division of the Office of Inspector General has conducted criminal investigations of 31 SBIC's and five portfolio companies. During this same period of time, other allegations of fraud involving four SBIC's and four portfolio companies were referred to the Federal Bureau of Investigations due to resource constraints within our office.

These allegations include the use of false statements to obtain Government funds, misapplication, misappropriation of funds, conversion of collateral, embezzlement, and money laundering. Potential Government losses due to fraud in these cases exceed $168 million. Interestingly, these investigations have been almost equally divided between the two programs.

As a result of these investigations, 11 investment company officials and associates and one portfolio company owner have been convicted of various criminal statutes, and over $54 million has been returned to the Government through court-ordered restitution, fines, savings, and other recoveries.

There have also been some administrative sanctions; that is, three investment companies have been removed from the program, one denied additional leverage, and one other which voluntarily surrendered its license. As my colleague from GAO noted, 20 of these 44 investigations are still ongoing.

The majority of cases involving SBIC's are initiated by referrals from SBA employees. Of the 54 referrals we received since 1988, 34 were generated by SBA officials. The remaining referrals come from other law enforcement agencies, private citizens, lenders, U.S. Attorneys Offices and, of course, media sources.

It is somewhat disturbing that well over half the referrals involving SBIC's are received from outside the agency or from the agency offices that are responsible for their liquidation. This situation suggests to me that fraud activity goes undetected by SBA program officials until either all the funds are expended or owners of the portfolio companies lose their investments.

Certainly, earlier recognition by the Investment Division would help in our efforts to deter such fraudulent activity. In an effort to correct this situation, we have been working very closely with the Investment Division, i.e., the Office of SBIC Examiners in particular, to resolve this fraud reporting problem.

For example, last year my Investigations Division developed and presented a fraud awareness training course to the Investment Division's examination staff. The course was designed to identify those fraud indicators which have been discovered over the course of our investigations.

Now on a more positive note, I would like to turn to some best practices that we have observed in the program. Consistent with the administration's emphasis on identifying and encouraging good program operations throughout the Government, my Inspection and Evaluation Division recently concluded a study of SBIC best practices.

Our goal, simply stated, was to identify common denominators of success that might be resident in the most successful SBIC's for the possible replication in those companies that were still struggling to become profitable.

Our August '94 report identified seven factors common to financially successful SBIC's. Based on case studies of nine SBIC's, including two SSBIC's, the study, not surprisingly, documented that profitable SBIC's: Are headed by managers who are well-qualified in terms of their work experience and academic backgrounds; offer compensation packages and intangible benefits sufficient to attract and retain high quality personnel; are adequately capitalized; follow good cash management principles; adopt investment strategies that generally minimize risk; employ a systematic approach to identify, evaluate, and structure investment deals that monitor closely the financial health of their portfolio companies to protect their interests; and, last, provide needed financing and technical assistance to their portfolio companies, thereby increasing their net worth.

Our findings also revealed that failures of SBIC's are largely attributable to deficiencies in SBIC managers' qualifications, their business practices, and their integrity. Second, the lack of adequate private capital to sustain the SBIC's also contributes to their rate of failure.

I want to stress that I believe the agency's new regulations will, over time, serve to reduce the licensees' failure rate. The regulations now require licensees to demonstrate that their management has the knowledge, the experience, and possesses the capability necessary for investing in the types of businesses contemplated.

I have recommended to Mr. Stillman and other policy officials in the agency that the Investment Division disseminate to all its licensees a summary of these "best practices" as reported by my office to be used as a model for operating a profitable SBIC.

In my judgment, the Investment Division should also require that both its operations and examinations staffs assess the presence of these best practices as part of their respective program monitoring activity.

Now I would like to quickly turn to the question of just how does one measure SBIC Program effectiveness. I believe the key to assessing the effectiveness of the program is to determine the impact that these licensees have had on the growth of their portfolio companies. Admittedly, this may be a difficult task. However, useful measures of success would be the number of jobs, revenues, and taxes generated.

The agency's new regulations do, in fact, require SBIC's to assess and report annually the economic impact of each financing according to such acceptable measures of performance. In my judgment, this requirement is a major step forward.

In our best practices inspection we suggested the division work to assure comparability in economic impact data by developing specific guidance for the SBIC's to use in collecting and reporting such data.

We also suggested that the division require the licensees to specify, in their annual impact reports, the dollar amount of each financing in proportion to other sources of financing received by the portfolio company. In this way, the SBA will be able to estimate more accurately the extent of the SBIC's impact on the economy.

Turning to auditing activities contributed since the October, 1992, transfer of the examinations function from my office to the

Investment Division, the Auditing Division has substantially reduced its oversight activities in these two programs. Our auditing focus has appropriately, in my judgment, shifted to the balance of the agency's activities, especially the 7(a) loan program and the 8(a) minority enterprise development program, both of which had received precious little oversight by the OIG in the past.

I would note, however, that our planning guidance for fiscal 1995 to fiscal 1997, copies of which have been given to the committee, calls for an internal audit of the Investment Division's examination functions by the close of fiscal 1997. In short, we will go in and take a rigorous look at how they are indeed managing this examination function.

Our main audit activity over the past 3 years has really consisted of just two audits: First, an audit of SBIC liquidation activities; and, second, an audit of the proposed merger of three SBIC's involving the preferred stock buyback program.

The liquidation audit reviewed the adequacy of procedures for controlling and liquidating assets acquired from failed SBIC's or from those that were in the process of going out of business. The audit found deficiencies in the agency's stewardship of the program—outdated policy guidance; significant differences between written procedures and actual operations; little or no evaluation of fair market value of acquired assets; a lack of required liquidation plans; delays in the transfer of financially troubled licensees for liquidation which, in turn, reduced recoveries of Government funds; delays in closing receiverships which resulted in reduced recoveries; failure to report some settlement agreements as compromises so they would be reviewed by SBA's own compromise committee; and, last, a need for better control over assets.

In response to the audit, the agency's Associate Administrator for Investment generally agreed with our recommendations, and records, maintained by the agency's audit follow-up system, clearly show that our recommendations were implemented.

The audit of the proposed merger of three SSBIC's was conducted in response to an anonymous complaint that the merger would violate regulations and would result in losses to the Government because the surviving company would be able to participate in the preferred stock buyback program. We concluded that the approval of the merger precluded SBA's ability to recoup most of the $3.8 million of preferred stock and dividends in arrears, that is, from an inactive SSBIC which had the ability to repay SBA in full.

As part of the merger, the first company planned to distribute $450,000 of its private capital to a holding company, contrary to the Small Business Act requirement that, prior to any distribution, all accumulated dividends be repaid. SBA's acting General Counsel, however, interpreted the law to pertain only to distributions from retained earnings, not from private capital. Three other regulations were also waived to permit the merger.

The agency believed the merger was in the best interests of the program because the decision kept the three firms' resources available for investment to small business and a merged company could raise another $3 million over the next 5 years.

If, on the other hand, the two inactive companies were liquidated, $3.8 million would have been deposited in the Treasury

and the fund would not have been available for the small business investments.

Based on historical data, we calculated that only $735,000 would be added to the private capital of the licensee at a cost of $2.8 million to the taxpayers. This equates, essentially, to the amount owed to the Government which would have been lost if the merged company would be allowed to participate in the preferred buyback program.

During the audit, the merger was approved by the then-Associate Administrator for Investment and thereby rendering some of our audit recommendations moot; therefore, we recommended the Government reduce its potential loss by not allowing the merged company to repurchase preferred stock at a discount. I don't believe that a repurchase action has happened to date. Senior management rejected our recommendation to prohibit any discounted buyback of the preferred stock in the future but, as I said, nothing has happened to date.

The Investment Division subsequently published a notice using these same guidelines. We objected, of course.

Finally, in August, 1990, we had a program of reviewing CPA's that conducted independent audits of the SBIC's. Unfortunately, we have had to abandon that oversight initiative for lack of resources.

I have essentially summarized my testimony. While I could offer some general comments on some of the regulations we reviewed, I will yield in the interest in the committee's time.

[Mr. Hoobler's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much, Mr. Hoobler. Our fourth witness is Mr. Will Dunbar. Mr. Dunbar is the president of Allied Capital Corporation and Allied Investment Corporation, an SBIC here in Washington.

Mr. Dunbar is here today as chairman of the National Association of Small Business Investment Companies, which represents the SBIC industry.

TESTIMONY OF WILL DUNBAR, CHAIRMAN, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. DUNBAR. Thank you, Madam Chairman, members of the committee. Good morning. I very much appreciate the opportunity to testify today to give my perspective on the current status and future of the SBIC Program.

I am testifying in my capacity as chairman of the National Association of Small Business Investment Companies and I serve as president of Allied Capital Corporation II and of Allied Investment Corporation II, which is a wholly owned subsidiary which is an SBIC with $10 million in funded capital.

I also serve as executive vice president of all the other funds managed by Allied Capital, which includes a second SBIC and an SSBIC. Allied holds the oldest SBIC license, having been founded in 1958.

I would like at this time to submit my written testimony for the official record of the committee and to focus my oral comments on a brief overview of the program and its future from my perspective.

Chairwoman MEYERS. Without objection.

Mr. DUNBAR. Thank you. As has been stated earlier, the SBIC Program was created in 1958 to help fill the funding gap that exists for small businesses. The most critical needs small businesses have is access to patient, long-term capital.

Long-term capital is of critical importance because it takes many years to build a company from early stage to the point where it is self-sustaining financially. In addition, these small companies need guidance and advice from experienced small business investors.

During the last 35 years, the industry has invested $12 billion in nearly 100,000 growing small companies. The need for capital and for management assistance that is fulfilled by the SBIC Program is even greater today than it was in 1958, and that is why the program is currently experiencing extraordinary growth in participants seeking to serve this niche.

In short, the companies that the SBIC industry serves do not have access to bank financing or to loans from the SBA 7(a) guaranteed loan program because they don't have assets which the lenders require to collateralize their loans. They can not go to Wall Street because they are too small to go public and their financing need is too small to cover the commission a Wall Street firm would require.

Venture capital is not a viable alternative because venture capital firms generally do larger deals, usually focus only on high technology industries, and are generally concentrated in major capital centers such as Boston, New York, and California.

Furthermore, this segment of the capital markets has been extremely cyclical in recent years, both in terms of funding from limited partners to venture capital firms and in size of investments by venture capital firms into small growing companies.

I would like to emphasize the point made earlier that in the SBIC Program the private capital is at risk first. That private capital under the new program is a minimum of $2.5 million, and for most SBIC's it is $10 million. This represents a reserve which stands between the Government and any potential losses.

Some of the companies that have been financed by SBIC's are high profile success stories like Federal Express, Cray Research and Intel, but many others are not well known but have, nevertheless, experienced phenomenal growth in employees, revenues, and Federal tax dollars paid.

My company invested in 1990 in a lumber dealer in Atlanta, Georgia, called Williams Brothers Lumber. We invested $865,000 at a time at which the company was in the process of being shut down by the British corporation that had bought Williams Brothers' parent company.

The CEO who had been brought in to liquidate the division and fire several hundred employees came to me with a proposal to buy the company from the British corporation. Over the intervening months we developed a proposal to do that, purchased the company in 1990, and today that company employs over 300 people and has sales of over $100 million a year, growing from $20 million at the time of our investment.

Another example is a maternity wear retailer in Pennsylvania called Mothers Work, in which an SBIC invested $250,000 in 1982. Today the company has $90 million in revenues and 359 stores.

Another fairly mundane example is a diner in New York called Cobbleskill Diner, in which two SBIC's invested $750,000 in 1990 in a startup restaurant which today employs 45 people and generates sales of over $1 million.

There are literally tens of thousands of examples like these. The point is that these are companies that are not being served by other segments of the capital markets. They generally represent fairly mundane industries like retailing, wholesaling, manufacturing and service companies, and most are in areas that do not have access to other forms of capital.

Offsetting these accomplishments were some problems in the late 1980's, as have been described by Mr. Hoobler and Mr. Wells. In response to these problems, which were generated by a combination of both regulatory abuses and by the inherent problems in the design of the program, as Ms. Ryan described earlier, the industry and Congress and SBA worked closely together from 1990 to 1992 to develop a response to these problems. That response developed into a total overhaul of the program, which was signed into law by President Bush in 1992 but which did not take effect until April, 1994.

This involved fundamental changes to the program which have been described earlier. The effect of this overhaul is that there has been an infusion of new management talent and new private capital into the industry. New private capital of over half a billion dollars has come into the industry in the last year, six times the amount for the previous 5 years combined. This capital is coming from new management teams that have successful track records that are subject to new due diligence review policies by the SBA.

On February 22nd, just a few weeks ago, we had the first funding of the new participating security guaranteed by the SBA. Nine SBIC's raised $73 million to invest in small businesses. I spoke with one of these, an SBIC manager in Kansas, who was currently investing in seven early stage companies. I emphasize early stage because it is the new participating security that enables him to invest in companies that can not generate sufficient income to pay interest to the SBIC.

Furthermore, the overhaul of the program has generated new interest in the traditional debenture program as well, and this has led to a potential for a dramatic increase in funding by the SBIC Program to small businesses.

However, we recognize the fiscal realities of the day and the industry is attempting to answer Congress' call to find some way to cut the cost of the program and to increase the role of the private sector in the SBIC Program.

This is essentially continuing along a continuum which had started several years ago. In 1989, the program moved from direct funding from the Federal financing bank to an SBA guarantee. In 1994, Congress increased the proportion of private capital which each SBIC must have.

We believe that possibly the next step along this continuum is developing a privatized entity which would fund and oversee the SBIC Program, perhaps outside of the SBA.

There is currently an industry task force working to develop policy options, which include a complete study of possible privatization

alternatives, and we hereby commit to this committee to present our findings and policy recommendations to you the first week after the Easter recess.

The goals of such a privatized entity would be to create a means for continuing to raise capital to provide to small businesses while reducing or eliminating the need for direct annual appropriations by Congress and providing a means for Government oversight of the new entity.

I thank you very much for the opportunity to testify today. These subjects are of vital importance to the future of the SBIC industry and its continued ability to provide patient, long-term capital to small, growing companies. We look forward to this committee's continued oversight and support in meeting this goal. Thank you.

[Mr. Dunbar's statement may be found in the appendix.]

Chairwoman MEYERS. Our fifth witness is Mr. Terry Jones. Mr. Jones is president of SYNCOM Capital, an SSBIC located in Silver Spring, Maryland.

Mr. Jones is also a member of the advisory council appointed to study the SSBIC industry and he is here today in his capacity as chairman of the National Association of Investment Companies, the association representing the SSBIC industry.

Mr. Jones.

TESTIMONY OF TERRY JONES, CHAIRMAN, NATIONAL ASSOCIATION OF INVESTMENT COMPANIES

Mr. JONES. Thank you, Madam Chairman. Good morning to you and the members of your committee. In addition to the responsibilities you named, I also am the general partner of Syndicated Communications Venture Partners II, L.P., which is a limited partnership that I mention because it is a private equity partnership funded by some of the country's largest pension funds.

The members the National Association of Investment Companies (NAIC) include investment companies licensed and regulated by the U.S. Small Business Administration, privately owned venture capital firms and quasi-private investment companies chartered by State and local governments, all of us engage in minority-focused investing.

On behalf of NAIC, I am pleased to have the opportunity to discuss with you today focused investment, investing in small businesses, and the SBIC Program in general.

Your letter of invitation asked me to consider a number of specific issues with respect to the SSBIC Program, such as financial returns, budget issues, and the SBA Program management. These issues are very important to us and I think they must be discussed in their proper context.

Madam Chairman, we think it's absolutely critical that the committee and the Congress and the SBA and the licensees themselves have an honest conversation about this topic.

One of your questions to me was: Is the SSBIC Program still necessary? Perhaps a more appropriate question might be: Is it in the national interest to promote and provide incentives to facilitate the flow of private capital toward small business concerns owned by socially or economically disadvantaged entrepreneurs? Is it in the national interest to do this?

In answering this question, we must determine whether the program promotes the public good and, if it does successfully, is it cost-effective as well. I can assure you that my colleagues and I spend long, long hours attempting to efficiently direct capital into the most viable opportunities, providing support for businesses in which this capital is invested and maximizing the return to the providers of that private capital, which includes capital provided from the Government.

Many of us have been involved in this industry since the initial inception of the program back in 1972. Quite frankly, we are proud of our accomplishments and believe we are all the more wiser for our mistakes. We believe that the SBIC industry has been a success and will continue to make a significant contribution to small business development in this country if it is allowed, Madam Chairman, to operate in accordance with the realities of today's business environment.

We have nurtured a significant number of small business which are now profitable enterprises. You have heard the statistic's and by now statistics sort of make our heads numb. But over the last 20 years, in excess of a billion six has been invested in 16,000 or 17,000 companies by this industry, the SSBIC industry. That's 17,000 companies.

It is estimated that those investments have created and sustained over 160,000 jobs. That's approximately 10 jobs per company. Interestingly enough, most of those jobs have been generated and are maintained in the minority communities of this country.

Tax payments by these licensees and their portfolio companies are well in excess of Federal leverage. Even the tax payments by the SSBIC's themselves, as you have heard this morning, are at least equal to and probably in excess of the leverage that the Government has provided, not to mention the income taxes paid by the employees themselves.

Now, our ability to accomplish even more than this has been constrained only by the lack of capital, and all too often, by an unreliable and unpredictable partner, the SBA itself. You also asked how the SBA, in our opinion, could improve the program. Well, first on my list would be regulatory relief.

With regard to the regulatory process, we understand that the SBA exercises administrative discretion whenever it perceives the freedom and ability to choose among possible courses of action.

In the case of the SSBIC industry, the course of action often chosen by the SBA leads to the inevitable conclusion that there is a strong distrust for SSBIC managers, upon whom, by the way, this program's success ultimately depends.

Regulations that restrict and control the investment managers' ability to make good business decisions diminishes, not increases, the capacity for creativity and for capably being able to respond to changes in the market place.

To be successful in the venture capital industry, investmen managers must maintain sufficient flexibility to execute their business plans in a prudent and business-like fashion. Unnecessary constraints on the licensees reduces their viability and, therefore, also reduces the potential return to the Government and other investors.

Madam Chairman, relaxing the regulatory burden for 301(d) licensees is consistent with good business practice and it is also compatible with the Republican party's business philosophy.

Secondary market access is another topic where improvement could be made. Another positive improvement in the SSBIC Program which could easily be implemented by SBA would be to make secondary markets accessible to SSBIC's by permitting them to qualify as participants in the SBA 7(a) guaranteed loan program.

This would be particularly beneficial to debt-oriented SSBIC's because all SSBIC's or SBIC's are not alike. Some primarily invest with debt instruments; others are more equity-oriented, depending on a number of factors.

By selling the guaranteed portion of SBA loans in the secondary market, SSBIC's could generate a much larger dollar volume of overall lending than would be possible utilizing only their capital and SBA leverage. Liquidity would be enhanced and more loan dollars would flow to small business enterprises. In this regard, NAIC has initiated discussions with the SBA to institute a pilot program along these lines.

Liquidity would also be enhanced by another improvement in the program that would permit SSBIC's to devote some percentage of their assets to short-term debt forms such as revolving credit line. The demand for these types of loans are indeed significant and being in a position to capitalize on this opportunity would give a greater return and more security to the Government.

A final suggestion addresses the SSBIC advisory council, which has been referred to earlier today. That the efforts undertaken by that advisory council and the SBA to improve the program should be given greater attention and focus in advancing the fundamental mission of the program.

We expect that that program will provide a comprehensive review envisioned by the council and would ultimately result in recommendations that could benefit the Congress and this committee in particular as you continue your review of SBA Programs. Quite frankly, we are confident that a vigilant review of the program will demonstrate just how successful this program has been, as well as its potential for greater success.

Wrapping up here, I will mention that the administration's fiscal year '96 budget is a great disappointment to us because only $15 million was appropriated or requested by this administration for both the direct funding of SSBIC debentures and for the preferred stock leverage.

This low level of funding is a continuation of a significant decline in recent years in funding for this program. For example, in 1994, the funding was decreased from $48 to $32 million in '95, to $30 million now in '96. Assuming that this is the amount appropriated, it is far from capable of fulfilling the estimated $50 to $70 million that we believe we need in leverage for our new and existing licensees.

My final comment, Madam Chairman, is that our mission is really quite straightforward and simple. We have a goal, which is to continue and be the catalyst for the development, or at least a major bridge for the development for small business in this country. That goal is to execute a strategy for efficiently aggregating

and prudently deploying capital to undeserved entrepreneurs to build strong and profitable enterprises.

Under no circumstances should minority and small business focused investing be regarded as social welfare activity. While the derivative results of our investment activity yields substantial social good, such as jobs and tax revenues, these benefits stem from solid business acumen and sound economic decisions. We are company builders and we serve a market that has been largely and traditionally and continuously neglected by traditional financial sources and intermediaries, especially the equity investment community.

Importantly, and I believe this is as important as anything we have done, we have developed a cadre of talented investment professionals over the last 20 years who understand this marketplace and who have demonstrated the ability and the commitment to structure investment opportunities so that they are able to realize their full potential.

Madam Chairman, I would encourage that a meaningful dialogue on all of these issues take place, as it has begun, I believe. Those of us who have been involved with the SSBIC Program for a number of years strongly believe in the program's purpose and its potential.

Moving forward, let us focus on the opportunities provided by this program, not be distracted by the difficulties which inevitably accompany the creation of successful businesses. Let us begin an honest dialogue that results in a stronger program and a program that enhances, not detracts from, our ability to attract new private capital.

This approach will allow qualified investment managers to successfully aggregate and deploy capital into enterprises which yield long-term benefits for the Nation's economy and provide for the general welfare of the United States.

Thank you again for the opportunity to share our views with you, and I request that my written, more detailed, testimony be submitted for the record.

Chairwoman MEYERS. Without objection.

[Mr. Jones' statement may be found in the appendix.]

Chairwoman MEYERS. Thank you, Mr. Jones. Our last witness is Mr. William Thomas. Mr. Thomas is the president and chairman of Capital Southwest Corporation, an SBIC in Dallas, Texas. Mr. Thomas was formerly a member of the Investment Advisory Council and is a past chairman of the National Association of Small Business Investment Companies.

Mr. Thomas.

TESTIMONY OF WILLIAM R. THOMAS, PRESIDENT, CAPITAL SOUTHWEST CORPORATION

Mr. THOMAS. Thank you, Madam Chairman, distinguished committee members and staff. First, I would request that my written testimony be included in the record of the committee.

Next month I begin the 34th year of my venture capital career, all at Capital Southwest. Previously, I held management positions in the chemical industry and with a consulting firm and was an army officer for 5 years, including a year of combat service in Korea, all of which equipped me for the venture capital business.

My education includes a B.S. from Texas A&M and an M.B.A. from Harvard Business School. As you indicated, I previously served as chairman of the National Association of SBIC's and I also participated in the Investment Advisory Council.

In addition, I have served as a governor of the National Association of Securities Dealers and chairman of the NASD's corporate advisory board.

To tell you a little about my company, Capital Southwest Corporation, which is a publicly owned venture capital investment company, is the largest such company in the country, with net assets of $135 million. When it was formed in 1961, our company was one of the more than 40 publicly owned SBIC's. That number has diminished considerably. Today there are only a handful of public companies operating in the program.

Today we have an SBIC subsidiary which holds approximately one-third of our assets and has issued an outstanding $11 million of SBA guaranteed debentures. The remainder of our assets are held by the parent company, which is a business development company not subject to SBA regulation but subject to the Investment Company Act of 1940.

On a consolidated basis, Capital Southwest and its SBIC subsidiary have investments in 33 portfolio companies and have achieved above average investment results. During the past 15 complete fiscal years ended March 31, 1994, our net assets have grown from $18 million to $133 million, and net asset value per share has grown at a compound annual rate of 19 percent, assuming reinvestment of all dividends and credits for taxes on retained capital gains.

During this entire 15-year period, an average of only 10.8 percent of our capital was derived from SBA guaranteed debentures on a consolidated basis, and at all times we had the resources to retire those debt obligations.

Our company, incidentally, was one of the nine SBIC's interviewed by the IG to identify best practices previously discussed by Mr. Hoobler in his testimony.

Now I would like to offer a few observations on the SBIC Program. The SBIC Program has been a Government Program that has worked. In fact, it has worked so well that it will be feasible to eliminate Federal funding and guarantees in the near future. The following observations I would offer in support of this position.

First, SBIC's, which now have something on the order of $3 billion in private capital and SBA leverage represented less than 10 percent of the $34.8 billion in venture capital under management throughout the country at the end of 1993. This comes from Venture Economics Inc. data.

This aggregate venture capital pool is nearly three times the $12.1 billion reported in 1983 and nearly 12 times the $3 billion that was estimated by Venture Economics as of 1973. Thus, the SBIC Program which had been contracting prior to the introduction of this latest revision of the program, has been an effective pioneer for a robust venture capital industry which has attracted major amounts of capital without Government subsidies or intervention. Twenty years ago, SBIC's were an important factor in the venture capital industry. Today their importance is minimal.

A second observation, SBIC subsidiaries of commercial banks, which represent a majority of the private capital in the program, do not, in most cases, rely on Federal funding, but use their SBIC's to avoid Glass–Steagall ownership limitations and, in most cases, are enrolled in the SBIC Program for that reason only.

A further observation, the vast majority of SBIC's have investment objectives which are identical to the objectives of non-SBIC venture capital firms. For example, in 86 percent of the investments made by our company during the past 6 years, non-SBIC venture capital firms have either competed with us, co-invested with us, or both. The other 14 percent of these investments would have been attractive to many non-SBIC venture capital firms had they gotten into the competitive bidding.

A critical observation: the redesigned SBIC Program will inevitably produce unintended consequences. The new participating preferred, which on a risk-reward basis appears to be tilted in favor of SBIC owners at the expense of taxpayers, is attracting a horde of opportunists, many of whom could instead raise capital from the private sector as they have in the past.

Interest in forming SBIC's has also been stimulated by the major increase in size standards, thereby permitting investments in some businesses which seem too big to be classified as small.

The product of these factors will inevitably increase the crowd at the Government trough and cause taxpayers to subsidize venture capital activities which the private sector is already funding without Government involvement.

Another observation: an SBIC Program which provides federally guaranteed funding through either debentures or participating preferred securities, interferes with capital markets and deprives nonparticipants of a level playing field. To obtain capital at the lower cost promised by the new participating preferred, non-SBIC venture capital funds will be drawn increasingly to the SBIC Program, as opposed to the private sector sources which they have relied on in the past.

Try as it may, the SBA will never be able to allocate capital as effectively as entities that are governed by the marketplace and are politically independent. This has been proven again and again since the inception of the SBIC Program, as the SBA has at times imprudently issued licenses to unqualified, unethical operators and, thereby, lost the taxpayers' money.

A further observation regarding the SSBIC Program, this program has indeed enabled a limited number of socially and economically disadvantaged entrepreneurs to participate in the free enterprise system; however, I believe it should provide financing only to disadvantaged minorities.

Unfortunately, the scope of the SSBIC Program has been broadened beyond minorities to include enterprises managed by women and Vietnam veterans. In view of the desirability of developing minority businesses, I would advocate tax incentives rather than Federal funding as a better way to encourage large corporations and financial institutions to increase their investments in SSBIC's.

Now, I would like to point to a few rationalizations that are often given in support of the SBIC program by advocates of Federal funding or guarantees. At one time, some of these claims had valid-

ity; today, they have far less merit. Several of the usual special interest arguments and my responses are as follows.

Rationalization number one: There is an acute shortage of venture capital. In fact, there is not a shortage, as evidenced by the pool of $34.8 billion of venture capital in 1993 and the obvious degree of competition among venture capital firms.

Although the February, 1992, report of the Investment Advisory Council to the SBA administrator states, "Institutional funding to the venture capital industry is in sharp and continuing contraction," new capital commitments have instead, according to Venture Economics, promptly rebounded from a low of $1.3 billion in 1991 to $2.5 billion in '92, $2.5 billion in '93, and an estimated $3.8 billion in 1994.

Investment activity also has soared during 1992, '93, and '94. In recent years, too much venture capital has been chasing too few good opportunities.

Rationalization number two: SBIC's serve different markets than non-SBIC venture capital firms. As discussed earlier, the vast majority of SBIC's have investment objectives identical to non-SBIC venture firms. Non-venture SBIC's engaged in spread lending hold less than 20 percent of the SBIC industry's assets and generally finance small enterprises with little or no growth potential. Also, geographic diversity of SBIC's is of little importance since venture capital firms will travel anywhere anytime for rewarding investment opportunities.

Rationalization number three: SBIC's have been primary financing sources for outstanding growth firms. Some of the SBIC promotional material implies that the industry was primarily responsible for developing an array of outstanding growth firms, including Apple, Intel, and Federal Express. A more accurate description would also credit the many non-SBIC venture investors in such firms with a large measure of these investment successes.

Finally, my recommendations. The SBIC Program, while far from perfect, has been the cornerstone of today's venture capital industry and it has been an effective one. However, the SBIC Program has now served its purpose and this is an appropriate time to declare victory and either phase it out or privatize it. To achieve this objective, the following steps are recommended.

First, suspend all further Federal guarantees or financing of SBIC's and SSBIC's except future maturities of existing debentures, which would be extended to mature in 2002. Existing debentures with later maturities would, of course, be due as scheduled. These actions would provide an adequate time period to either liquidate established portfolios or refinance existing indebtedness.

Second, devise tax incentives to encourage the formation of SSBIC's by large corporations and financial institutions. For example, there could be a deferral of taxes on capital gains retained for reinvestment by the SSBIC.

Third, continuing licensing of privately funded SBIC's would be desirable, either through the SBA or another Federal agency. This would accommodate banking institutions which require Glass–Steagall exemptions and other entities which are attracted to the SBIC Program by the ordinary loss treatment of SBIC stock invest-

ments and by the use of SBIC's to make investments qualifying for the targeted capital gains tax rate.

Finally, as an alternative, it may be feasible to privatize the entire SBIC industry on a basis which involves no Federal guarantees or backstops, but enables the industry to sell securities on a pooled basis to meet its financial requirements. Any such privatization should remove the entire program from the supervision of the SBA or any other Federal agency and, as a quad pro quo, relieve the Government of any guarantee obligations on future financing.

My comments have been limited to the SBIC Program, although I have attached a letter dated January 16, 1995, to the Honorable Jan Meyers which also sets forth a number of observations on the SBA. In this connection, I would say that the SBA's broad array of activities must be viewed as a primary candidate for elimination, along with the SBA itself.

Among the programs that I feel are unreasonable and, in effect, use the taxpayers' money for improper purposes, are the Guaranty Loan Program, which is systematically enriching the Nation's banks and other lenders at the expense of the taxpayers. Also, the SBA 8(a) Program which grants Government contracts on a preferential basis to certain bidders.

As your committee conducts a critical review of the many facets of the SBA, I believe you will find that small business is vital to our economy, but the Small Business Administration is not. I appreciate the opportunity to testify and welcome any questions.

[Mr. Thomas' statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much, Mr. Thomas. We will now proceed to questions. I guess maybe the first thing that I would like to do is, Mr. Dunbar, I wonder if you would respond to some of the things that Mr. Thomas has just said. I think a kind of a point-counterpoint might be helpful to the members of the committee.

Mr. DUNBAR. I would be happy to try, Madam Chairman. Mr. Thomas, first of all, I should point out, is a longtime friend of mine and my firm's for as long as I have been in the industry and I have tremendous respect for Bill Thomas and for the company that he has built at Capital Southwest. Nevertheless, I do take issue with a number of the things that he has raised in his testimony.

Let me point out that he has made many statements with which I wholeheartedly agree, that the SBIC industry was the grandfather and the training ground for the venture capital program, and a large number of the SBIC's are banks who can only participate in equity investing through the SBIC Program, and that there have been problems at SBA in the past with some of the people who have been licensed into the program. I believe that has been fleshed out very well here today.

I believe the fundamental disagreement that I have with Mr. Thomas is that the venture capital industry can and does serve the same pool of potential small businesses that the SBIC Program does.

Specifically, I would point out that he pointed out that he looks at many investments that venture capital firms also look at. That goes for Allied Capital in some cases as well because Capital Southwest and Allied Capital have reached a size where we are as

large as some of the venture capital firms, certainly not many, but some of them.

But when you look across the industry as a whole, the venture capital industry is almost entirely made up of firms that manage at least $100 million and many of them several billion dollars. For those firms, it is simply impossible for them to make investments of $100,000, $200,000, and $500,000, and these are the size investments that small companies need.

It is particularly impossible for a company, a venture capital firm that manages a billion dollars in Boston or New York or California to go to Mississippi or Kansas or other capital-poor areas and provide capital in small doses for early stage companies.

I maintain and I believe that the SBA—earlier Ms. Ryan made the case that the size investments are totally different.

Chairwoman MEYERS. You're saying then that you think the niche that SBIC's perform is that they will make smaller loans?

Mr. DUNBAR. There are a number of differences: One is they will make smaller ones; second, they are less focused on high technology businesses than most venture capital firms are; third, they serve a more diverse geographic area; and, fourth, the industry is and can be much less cyclical than the venture capital industry. I believe that——

Chairwoman MEYERS. How do you react to his saying that with the $34 billion in the venture capital industry it has really been, too much capital chasing too few opportunities and that it is really privately they will go anywhere anytime to make——

Mr. DUNBAR. Well, quite frankly, I think it is easy for those of us who are in the industry to say that we don't want more competition in the industry, but I believe that it is in the interest of the country to increase the amount of investment dollars that are available for small businesses.

I believe that there are a lot of small businesses that still cite access to capital as the most critical need that they have. I also believe that as the pool of capital grows in this country, the number of people who see the opportunity to go start small businesses and employ people and grow their businesses and pay tax dollars will increase.

Chairwoman MEYERS. While my light is still green I am going to ask Mr. Thomas if he would like to make a quick response because I would like to have time to ask Ms. Ryan a question.

Mr. THOMAS. First of all, there is, and I believe will continue to be, a high level of competition in the venture capital business, regardless of what happens to the SBIC Program. The marketplace will assure that. It will assure that if there are good returns on investments in the venture capital business, there will be capital, private capital, flowing into the business. We don't need to enlarge that pool by Government involvement.

Second, I will submit to you that there is a broad spectrum of venture capital companies. To characterize the non-SBIC venture capital industry as one that is populated by the Silicon Valley high technology component of the business is simply inaccurate.

There are venture capital firms who do prosaic investments and relatively small investments, and I compete with them every day. I participate with them. They will do a half a million dollar invest-

ment. Our firm, in fact, recently did a $200,000 investment. Not because we have an SBIC; it was because we thought it was an inviting opportunity.

To me, there is a contradiction in saying that the redeeming virtue of the SBIC Program is that it serves very small businesses. If that is the case, why was the size standard for small business concerns raised so dramatically to concerns having a net worth of $18 million and $6 million in after-tax income? These may be small to some people. They are not very small to others.

Further, why has the SBA set a minimum of $10 million in capital to obtain a license for the new participating preferred SBIC's—and actually had license applications averaging $16 million in capital. Is there an expectation that those SBIC investors are going to put $16 million on the line and finance regional, small Mom and Pop concerns? I would say no.

Further, does the SBA really have a charter to provide financing to small, small concerns regardless of their growth potential? I would submit to you that the compelling reason for financing should be to create employment and, unfortunately, that isn't done by financing Burger Kings.

Chairwoman MEYERS. All right. Thank you very much. I won't have time for my question right now, Ms. Ryan, because I am going to enforce the 5-minute time for both question and answer, and so I will do it to myself as well and would refer now to Mr. LaFalce.

Mr. LAFALCE. Thank you, Madam Chair. First, I think this has been an excellent and very well-balanced panel on a difficult issue.

Just out of curiosity, Mr. Thomas, you are from Dallas, Texas. I think they have a lot more venture capitalists down there than in Buffalo, New York. Do you know a friend of mine in Dallas, John Strauss?

Mr. THOMAS. John who?

Mr. LAFALCE. Strauss.

Mr. THOMAS. I'm sorry. I don't.

Mr. LAFALCE. He made his first 50 down there. We heard an awful lot of problems about the SBIC Program, but here is a report that was submitted to the Honorable Patricia Saiki, the Administrator of the United States Small Business Administration in February of 1992, and that is why they submitted legislation in 1992. Mr. Ireland and I jointly introduced that legislation. We passed it and it became effective April of 1994.

To what extent are the problems that we have heard discussed today problems that pre-dated the effective date of that legislation? For the most part, has that legislation been an adequate enough legislative framework to deal with the problems, or are there major significant problems that we still have that need new remedial legislation?

I ask that question as a separate question from the whole issue of privatization of the program, which is a separate issue which I want to go into after the first response.

Mr. Stillman.

Mr. STILLMAN. Thank you. I welcome the chance to respond to that. I came here, as you know, a year ago to lead the revitalization of the SBIC Program. I had spent 35 years in the private sector, 15 with one of the earliest venture capital firms and 20 with

another private investment firm. None of the firms that I have ever worked for have used any Government money whatsoever, so I come with an entirely private background.

I came here excited by the fact that the SBIC Program is a program that creates jobs on the one hand, and reduces the Federal deficit on the other hand. I am very pleased to have been associated with the new program which was announced in April 1994, which was built on the legislation in 1992 of which you speak. To me, it is an extremely effective way of providing a solution to virtually all of the problems that have been related to here.

Both the Inspector General and the GAO have made it clear that their reviews are principally the reviews of the old program. We simply don't have enough experience with the new one for them to have looked at it as yet.

For instance, of 20 companies that are under investigation, those investigations began back in 1988, 1991, or 1992. Those are all old companies. Similarly, as we look at what has happened since we announced the new program, we have addressed the major issues.

First, we have taken great care on the kind of people we are bringing into the program. The problems that have been cited are typically traceable to having the wrong people there.

Mr. LAFALCE. Mr. Stillman, I am afraid I am going to have to cut you off just so I can get a second question in. I thank you.

My second question is this: Despite the answer you have just given, which says most all these problems pre-date the evolution of the new program, clearly the SBA and the private sector participants are considering privatization, and that is something that Mr. Thomas advocated as an alternative to the present system too.

Well, privatization is something that I attempted to accomplish in the 100th Congress. Matter of fact, the Small Business Committee reported out a bill that would have totally privatized the SBIC Program. We couldn't get the then administration to go along with it because, in all candor, key to the concept were two points: A backstop, or implied Federal guarantee, and initial startup capital.

Now, it seems to me that those two problems are still going to be there. How are you, in your intellectual meanderings, dealing with the problems of the backstop, the implied guarantee, or the initial startup capital? I know Mr. Thomas talked about toolings, but I'm not sure how that would work.

Can you give us a glimpse of what we are going to see 3 of 4 weeks from now, Mr. Dunbar? Ms. Ryan, or Mr. Stillman, do you want to tell us some of the things you are contemplating?

Mr. STILLMAN. Well, do you want to lead off on that?

Mr. DUNBAR. Congressman LaFalce, I would prefer to defer most of that discussion until later. I will respond that we do believe that some sort of Treasury backstop will be required, so let me confront that right up front.

I agree with Mr. Thomas that a privatized program with no guarantees and no backstops is obviously the ultimate objective, and I believe we can get to that objective eventually. But when this privatized entity is a startup entity, if you will, I believe that some sort of backstop will be required. But I would like to have a more detailed discussion on that after we have done further analysis.

Mr. STILLMAN. We, sir, have a study group which is looking at a variety of alternatives for privatization. We are about to name a blue ribbon panel of private sector individuals who will review the analysis made by that commission.

Clearly, privatization has to address a variety of concerns at the same time: First, of course, to reduce or hopefully eliminate the budget appropriation requirement; second, to still have a program which provides the additional capital that the SBIC Program does to the venture capital industry in a way that works; and, third, to have a program which provides enough oversight to whatever extent the Government is involved in it to make sure the public purpose is served. We expect to have recommendations ourselves within the next month, at the outside.

Chairwoman MEYERS. Thank you, Mr. Stillman. Mr. Torkildsen.

Mr. TORKILDSEN. Thank you, Madam Chair. I also want to compliment you for being able to assemble such diverse opinions on a very important subject. I thank all the witnesses for their testimony.

Mr. Dunbar, just to go over a point in your testimony, you mentioned that, adequately funded, the participating security program has the potential to add billions of dollars of available capital for investing in small business at nominal cost to the Government with the possibility that the program may generate a profit for the Government.

Could you outline, what type of funding levels you are thinking of and any other changes that would be necessary and how likely you think that potential profit for the Government would be?

Mr. DUNBAR. I would be happy to try. As has been described earlier, the 43 licensees that have been approved since the new program was initiated bring a little over a half a billion dollars in capital, private capital, to invest in small businesses and there is the opportunity, of course, to leverage that through the SBIC Program.

The new program and the potential profitability of it relates to the fact that the participating security has a profit participation in the program. Essentially, the idea was to cure the mismatch between investing in early stage companies that couldn't pay interest and yet being forced to pay interest to the SBA; and then, second, to provide the Government an opportunity to share in some of the programs' successes that have been described earlier.

So we believe that because of the changes in the management of the program and the inclusion of the participating security, that there is the potential that the program, over time, the subsidy rate for the program, which is currently 9 percent for the participating securities, could actually be reduced to zero and perhaps even generate a profit over time if the industry continues to invest in successful companies as it did in the past.

The administration's request for the 1996 fiscal year budget was a program level of $270 million for the participating securities and $152 million for the SBIC debentures. Based on the current demand that we are seeing from the applicants who have been approved and the several dozen other applicants who have licenses pending at SBA, the program levels—the demand for the program levels would be far in excess of even those levels for 1996.

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Mr. TORKILDSEN. Under such a scenario, would you say that the market or the need would still be targeted to those firms which traditionally have not had access to venture capital, either for geographic location or the small size and their needs, or would it require more marketing to some firms that might perhaps be able to acquire capital in the private market?

Mr. DUNBAR. My understanding is that SBA has focused on approving applications in rural areas and in areas that currently are not well-served by other segments of the capital markets. So we believe that the new program would involve a tremendous increase in the geographic coverage of the private equity industry.

Mr. TORKILDSEN. Then just in general, to follow up on my colleagues earlier question, the whole nature of privatizing the SBIC which is called for in the study of the President's initiative, would anyone else on the panel, anyone care to comment on that?

Obviously, it has only been floated by the White House for the last 24 hours, but I would just appreciate any concerns or thoughts any of you might have, if I could throw that as an open question to you.

Mr. Jones.

Mr. JONES. You asked for a comment on privatization?

Mr. TORKILDSEN. Yes.

Mr. JONES. Our association supports efforts toward privatization. In fact, years ago when Mr. LaFalce mentioned the efforts, we were involved very intimately in that process and were very disappointed that it wasn't concluded because we think it would have been beneficial for all involved.

I also want to take the opportunity now that I have the mike to comment on some of Mr. Thomas' points just for the record. I too believe that a lot of what he said is correct and, in fact, would benefit the program and the country; however, I take issue to the world that he is painting as an efficient world of venture capital that really does aggregate and deploy capital in some sort of reasonable or even fair means.

Nothing is further from the truth. Venture capitalism is an elitist kind of industry. It is fundamentally based on relationships, relationships and, to some extent, experience, experience that often is obtained because of relationships.

The aggregation of that capital goes to very few hands because of the fiduciary responsibilities of the providers of that capital who have to do incredible due diligence, pension funds and others, and so most people in this country will never become venture capital managers or be involved with venture capital managers and those few venture capital managers will never interact with most business people in this country who, in fact, have the potential to provide the country with the innovation and the businesses going forward.

If, in fact, it were an efficient process, the companies that have been funded, particularly by the SSBIC industry, wouldn't have needed to be funded. The fact is the $34 million that exists in the venture capital industry, almost none of that is in the hands of either black, Hispanic, women, or other managers because it is in an elitist industry based on relationships.

Quite frankly, all of the portfolios, I believe, of most of the people who are involved in this industry, Mr. Dunbar's company, will look like them. The people they invest in are white males, quite frankly, because they are the people you have contact with.

Mr. TORKILDSEN. Mr. Jones, I am about to run out of time and I appreciate your comments.

Mr. JONES. I'm sorry.

Mr. TORKILDSEN. That's quite all right. I think it's a legitimate view point. In my remaining seconds, Mr. Thomas, if you would like to comment and respond, because I think it is a valid question.

Venture capital, is it a limited circle of people putting capital up to companies, or is it more open than would traditionally be described?

Mr. THOMAS. Well, first let me distinguish between those companies, SSBIC's that are created and focused on investing in minority enterprises. Whereas I would advocate a level playing field for the rest of the universe, I think that it is in the national interest to provide some advantageous structure for SSBIC's either through tax incentives or subsidized cost of capital.

But as far as the rest of the venture capital world, it is not very elitist. There are 600 and some-odd venture capital firms and I would acknowledge that there are a few of the really superstar fighter pilots out on the west coast who probably don't even speak to me because I fly a less glamorous plane.

But, nonetheless, there is a broad spectrum of diverse venture firms out there and they do, in fact, compete.

Mr. TORKILDSEN. Thank you, Madam Chair, if I may just conclude with one comment. In my question I don't want anyone to think that I was giving the President credit for the privatization idea. I know that many members of this committee and others have suggested it for some time. But I think it's a good point for us to discuss.

Thank you.

Chairwoman MEYERS. Thank you, Mr. Torkildsen. Mr. Bentsen.

Mr. BENTSEN. Thank you, Madam Chairman. Mr. Stillman, Ms. Ryan, yet the administration did yesterday and it introduced their reinventing the SBA proposal and they talked about privatizing the 7(a) Program, the 504 Program, both of which upon initial glance I think look promising and will increase the amount of capital, which is what I think the SBA ought to be doing.

I am curious why you didn't go further and look at and announce a privatization of the SBIC Program. You have said that you're going to study that, but I'm not sure why at this point you wouldn't have gone ahead. I realize it's different structure. It's a different debt structure. It involves equity. But why not?

Chairwoman MEYERS. And while you're doing that, Ms. Ryan, would you comment on why it is any different if we have an implied support for another sort of a GSE structure or continue to support it through the SBA? I can't see any real difference there.

Ms. RYAN. First of all, in the proposals that came out yesterday, I would be happy to talk to you more and I think Thursday's hearing will go into a lot of detail on that, I imagine. But we're not proposing technically to privatize either the 504 Program or the 7(a)

Program. We are proposing, through a combination of fee increases, to take the subsidy cost down to zero.

Mr. BENTSEN. It's a self-financing program, I guess, is a better way to put it.

Ms. RYAN. Right. But there still is the full administrative cost of the program, which is a separate expense category.

Mr. BENTSEN. Let me restate my question then, and you are correct.

Ms. RYAN. Right.

Mr. BENTSEN. And I actually think that—I mean, I like that idea better. The Chairman tried it. It does lead you, in some respects, toward a GSE type structure like Fannie and Freddie.

Ms. RYAN. Sure.

Mr. BENTSEN. And, again, why not with SBIC at this point in time to make it a self-financing to increase the amount of capital that would be available?

Ms. RYAN. We are really committed in the review of the SBIC Program to looking at whether it is possible right now for us to take the total step to true privatization or whether it will make sense to go part way.

It is already a fairly privatized program in many respects—it is also, frankly, a lot more complicated than a lot of the other programs that we have. The subsidy rates are much higher for the SBIC and much higher still for the SSBIC so the leap to self-funding is gigantic and it needs a lot more analysis.

As Congressman LaFalce said, there are a lot of issues that had come up in earlier reviews and proposals that will have to be confronted without losing the public policy benefit of the SBIC Program.

So we are committed to going literally as fast as we can but to do a responsible job, and we would have been irresponsible yesterday to announce something that wasn't well thought through. We look forward to working with you on it.

Mr. BENTSEN. Let me ask, is there any—have you seen much growth with respect to bank SBIC's or SSBIC's, I guess, as it relates—and tying that in with the CRA?

Mr. STILLMAN. The CRA Program has brought some money into the SBIC program and there is as much or more in the regular SSBIC Program where we have several SBIC's that have tapped bank financing, which gets CRA credits, a good example being Anthem Capital up here in Baltimore, which has been a leader in that field.

We have had relatively few SSBIC applications and none of the recent ones have been funded by banks seeking CRA credits.

Mr. BENTSEN. Let me ask—because we are on this time limit, let me ask you this—and Mr. Thomas brought up the idea of that banks are using this as—for a loophole for Glass–Steagall.

As you probably know, a couple of floors down from here we are holding hearings and many of us serve on the banking committee where we are looking to repeal Glass–Steagall. I think there is a good chance that that will occur and what the final structure will be is not clear, but probably giving banks more ability to get into some merchant banking activities and possibly some venture capital activities.

Do you think that that will have a negative impact on the SSBIC or the SBIC Program?

Mr. STILLMAN. It potentially may have some impact on us but the SBIC's are not certain that the repeal of Glass–Steagall would cause them to drop their SBIC Programs. There, of course, as you would well know, are other banking regulations that restrict equity investments by banks.

If those are still in place, they still will have to use their SBIC's for equity investing even if the banks, let's say, were all to drop out of the SBIC Program because the legislation was so liberal that they could make equity investments without that.

Still, at the present time 121 of our 182 regular SBIC's are nonbank SBIC's and they represent slightly over half the total capital; in other words, over $2 billion, of which $1.3 billion is private capital and $825 million is SBA guaranteed leverage. So we still have a very substantial program outside the banks.

Mr. BENTSEN. Thank you. Mr. Thomas, now, your firm started as an SBIC?

Mr. THOMAS. That is correct. It was 100 percent SBIC, and during its first 6 or 8 years we moved our SBIC to a subsidiary and we continue in that form. About a third of our assets are in that subsidiary.

Mr. BENTSEN. From your calculations or from your research, about 10 percent of—SBIC's now make up about 10 percent of the total pool of venture capital funds outstanding, or outstanding funds?

Mr. THOMAS. Yes, and I'm drawing on the Venture Economics data that they prepare for the NVCA and, in fact, you will find these numbers in the 1993 annual report of the National Venture Capital Association.

Mr. BENTSEN. But for the regular programs——

Mr. THOMAS. So it would be right at 10 percent, correct.

Mr. BENTSEN. And I'll finish right away, just to finish this line of question. But, I mean, do you think that we should at this point do away with the SBIC Program as it relates to the Government's involvement because it is a small percentage?

Mr. THOMAS. Absolutely.

Mr. BENTSEN. But, obviously, it helped start your firm along its way and many other firms and it helped create a pool of capital that is available. Even if it has gone from at one point perhaps—we don't know, but maybe being 20, 30, or 40 percent of the total pool of capital available to 10 percent, do you still not think that that's a significant amount in the marketplace?

I would agree that there are venture capital firms in Houston and my area, I know, that do high tech to low tech, so but still 10 percent seems fairly significant, and it did create firms like yours.

You think at this point we should close the door on that?

Mr. THOMAS. That was a very different era. At that time the SBIC's and a few of the early venture capital firms—and there were only a handful—were all there was. The way I view it, the SBIC business did demonstrate the feasibility of an institutional approach to venture capital.

It demonstrated it so well that people raised money independent of the SBIC business, and that is really what the marketplace has said. It has said, hey, we can subsist without Government funding.

What is happening now, of course, is that with the new participating preferred, capital is being drawn into the program, which I would submit to you in most cases could be raised in the private sector.

So we are creating here a Government Program that is going to suck capital out of the private venture capital business because it is a better deal and it would, in fact, cause me in the interest of our stockholders to continue in the SBIC program. While on the one hand I advocate eliminating it, on the other hand, I am entrusted by my shareholders to make the best return. So that says stay in this program.

Another thing I would point out to you is that the party line is that these newly licensed SBIC companies are being selected to provide a lot of regional flavor to this new participating security program. But as I look at this list, it appears to me that over 80 percent of the new SBIC licensees that are shown here on the attachment from the Private Equity Analyst article included in Mr. Dunbar's testimony are from major metropolitan areas. So I really question whether there is this thrust to put a SBIC in Paducah, Kentucky.

Mr. BENTSEN. Well, thank you, Madam Chair. I would hope just for the committee's purposes, based upon Mr. Thomas' statement, and I understand that participating securities are new, that the SBA might provide the committee with some data as it becomes available that shows whether or not this is supplemental capital that has come in or replacement capital, I think, as you would argue.

Thank you.

Mr. DUNBAR. May I draw one distinction here? The $1 billion in annual disbursements is actually about 25 or 30 percent of annual disbursements, and I think we need to distinguish that from the SBIC Program as a total of the pool because the $34.6 million pool of venture capital includes a lot of leverage buyout firms and other firms that have a billion or more dollars under management.

I think the key number is how much money is going to small businesses every year and, of that number, the SBIC Program is a significant percentage, about a third.

Mr. THOMAS. Madam Chair, may I respond to that?

Chairwoman MEYERS. Yes.

Mr. THOMAS. Because the venture capital pool, as defined by Venture Economics, does not include the KKR's of the world, it does not include firms that are predominantly leverage buyout firms. Now, many venture capital firms do leveraged buyouts and there is nothing sacrilegious about that. Many of them have proved to be the cornerstones for growth companies.

But, if you look at the estimated numbers for 1994 for the entire venture capital industry, as defined, exclusive of the leveraged buyout people, the venture capital people disbursed something on the order of $4 billion last year.

Mr. STILLMAN. Madam Chair, if I might beg your indulgence, just one clarification of this $34 billion figure. We are reading out of the

same hymn book on this side of the table because we all read Venture Economics data. It is very important to know that 91 percent of that $34 billion is held by firms that have capital of over $25 million, and the vast bulk of it is with firms that have $50 or $100 million dollars or more of capital to invest.

Those are the very firms that must, in order to keep an orderly investment profile, restrict their investments to the much larger investments. So that compared with the universe of companies of the size of SBIC's, the SBIC's are an extremely high percentage of those at $25 million or less of private capital.

Chairwoman MEYERS. I would like to ask if maybe members who are not here—I know some of them had questions and had to leave for other meetings—if they could submit questions to you, written questions to you.

Mr. Fattah.

Mr. FATTAH. Thank you, Madam Chair. Let me just ask a couple of brief questions. On the point that you just made, I understand that the average SBIC's total available capital is $18 million but there are some, obviously, if that's the average, that are over the $25 million mark.

But let me ask Mr. Stillman a quick question on the debt-to-equity ratio. There seems to be a great disparity between the SSBIC's debt-to-equity ratio as compared to the SBIC's.

Could you comment on why there is such a gross disparity?

Mr. STILLMAN. Well, the ratio of debt-to-equity, as you referred to, I presume, is in the case of the SSBIC's. we owe about $300 million of debt on top of $200 million of equity, or about ½ to 1; whereas, in the regular SBIC Program we owe a much lower ratio.

The regular SBIC Program, of course, includes the bank SBIC's that typically use no leverage at all. As Mr. Thomas has pointed out, in their case of $1.8 billion of private capital, they are only using $23 million of leverage because they typically are using the program as a way legally to make equity investments.

The non-bank SBIC figures are distorted by the amount of new capital that has come into the program in the last year, which is more than double the amount——

Mr. FATTAH. Could you provide the committee with some information on that?

Mr. STILLMAN. Certainly, sir.

[The information may be found in the appendix.]

Mr. FATTAH. Let me ask Mr. Dunbar a question. You are the head of the National Association of Small Business Investment Companies?

Mr. DUNBAR. Yes, sir.

Mr. FATTAH. What is the percentage of the deal flow to your association, if you know the information, for women-owned businesses?

Mr. DUNBAR. I'm afraid I don't know the answer to that, but we could try to do a survey of our member firms and see if we could provide an answer to you.

Mr. FATTAH. I would assume that the same answer would be so for African American-owned and Hispanic-owned businesses?

Mr. DUNBAR. Well, speaking from my own personal experience, we see a much greater deal flow from African American and Asian

American-owned businesses than from women businesses, but I couldn't speak for the industry as a whole.

Mr. FATTAH. Could you provide the committee with that information? I think that would helpful.

Mr. DUNBAR. I'd be happy to.

Mr. FATTAH. I think that's it for me, Madam Chair.

Chairwoman MEYERS. Thank you very much, Mr. Fattah. Mr. Luther.

Mr. LUTHER. Thank you, Madam Chair. Appreciate it. One question I would have, and this would really be addressed to anyone who would like to respond, oftentimes the criticism that you hear of the private capital market in our country is it attempts to focus on short-term rather than long-term.

So the question I would have as we consider this privatization concept, would there be any of what you might call short-term versus long-term considerations that we ought to be discussing, thinking about?

Mr. DUNBAR. Well, I think it's a very important distinction because the program, by definition, was created in order to help small businesses which do require long-term, patient capital. That is the important distinction and I think any type of privatized entity would be required to preserve that element of the program.

Certainly the participating security is an enhancement of that aspect of the program because it makes it possible to invest in a company without the requirement to have current interest on an annual basis.

Ms. RYAN. Another possible way of looking at the short-term/long-term question might be, as Congressman LaFalce was mentioning, in terms of our timeframe for implementing a privatized entity. There may be up front costs that will be a short-term cost to get to the long-term plan, which will have to be taken into consideration by Congress when it looks at any of these plans— what the short-term picture will be, as well as the long-term.

Mr. STILLMAN. And, also, because the investments or loans made by any kind of venture capital firm are almost always in unmarketable private companies, the program must address itself to a longer term because the timing of liquidity of those investments is always in doubt.

Mr. LUTHER. Thank you.

Chairwoman MEYERS. Thank you, Mr. Luther. Could I indulge myself here and take another 5 minutes, and then I think we will adjourn and ask for those who wish to submit questions in writing.

This question would be to Ms. Ryan and Mr. Stillman because there are some things that I don't understand. One, if the debenture program was the problem and that seemed to be the big problem, we were going to resolve it with participating securities, why is it still in existence? And it seems to be thriving and growing. Aren't a number of the people who are applying to get into the program are applying to get into the debenture program?

Mr. STILLMAN. Two answers, if I may, Madam Chair. The problem with the debenture program in the past was principally a mismatch of that program when applied by companies that were making equity investments that created no cash flow coming in to them, yet they had a cash flow out to pay the interest on the de-

bentures. That group of licensees is now much better served by the participating security, which does not have that current cash payment obligation.

There is another very important segment of the program though that continues to make its investments in the form of long-term loans, oftentimes with equity features, warrants or conversion rights attached to them. For them, since they do have cash flow coming in, they are able to apply that to debenture interest and it is a more economical and a better matched form of security for them.

There have been important changes in the terms of the debentures that we offer. A part of the problem was that debentures until 1992 had a heavy prepayment penalty beginning at the 6th year through the 10th year and, actually, they were forbidden to prepay the debentures at all during the first 5 years. That meant in a declining interest rate environment they were caught with high fixed rate debentures that they couldn't prepay without these tremendous penalties.

Chairwoman MEYERS. You are saying the new program is better than the old program because it allows prepayment?

Mr. STILLMAN. Yes, ma'am.

Chairwoman MEYERS. Tell me specifically.

Mr. STILLMAN. Yes, exactly that. We now allow prepayment after the end of 5 years without penalty. So if interest rates decline, rather than being stuck to continue paying interest they can just pay off the debentures.

Mr. DUNBAR. Could I expand on that?

Chairwoman MEYERS. Yes.

Mr. DUNBAR. There were a number of other changes to the program in that overhaul, in addition to the creation of the participating security and the changes in the prepayment options.

We increased the amount of private capital that every entity must bring to the SBIC. We increased the number of institutional investors that must invest in order to provide another set of eyes looking over the SBIC. We decreased the amount of leverage——

Chairwoman MEYERS. But do you mean this is in the debenture program?

Mr. DUNBAR. Yes, ma'am.

Chairwoman MEYERS. OK.

Mr. DUNBAR. We decreased the amount of leverage that an SBIC could have dramatically. Before there was no limitation on the amount of senior debt that an SBIC could put on top of the Government's leverage. So we have dramatically reduced the risk of default for those reasons.

We have raised the bar, if you will, on licensing new SBIC's and requiring due diligence of their past investment track record. We changed the way the guidelines for valuing companies in the portfolio in order to enable SBA to monitor better.

There was a massive overhaul of the entire program encompassing both the debenture program, in addition to the creation of and application of the new rules to the participating securities program in 1994.

Chairwoman MEYERS. Another quick question, Ms. Ryan. Your numbers don't seem to tally with GAO's numbers. GAO says there

is a $790 million exposure, a possible $443 million recovery, and this would seem to indicate that there is $347 million lost. You have said there is $253 million lost. That is almost $100 million difference.

Ms. RYAN. Right. We did a point-by-point comparison. We can go through it or provide it for the record, but we have it. We have it to the penny. If you want us to explain a little bit where the discrepancies come, it's fine.

Chairwoman MEYERS. I think you could provide it for the record, unless you can discuss it fairly succinctly.

Mr. STILLMAN. Perhaps I could quickly characterize it, Madam Chair. The $790 million that GAO refers to is the amount of leverage at the time they came into liquidation. We have already collected $174 million of that in cash. We have already written off $94 million of that, which brings us down to the $522 million figure that we have used as a starting point.

They have taken the initial amount of leverage when they came into liquidation; we have used the number as it stands today.

Mr. WELLS. We'll be glad to sit down and work the numbers through on both sides for you.

Chairwoman MEYERS. All right, thank you. I would be very interested in that and I think that the rest of the committee would, as well.

One other question, Ms. Ryan and/or Mr. Stillman, whoever, would like to—I noticed that some of these SBIC's have been in receivership for 20 years and that some of the receivers have been former SBA employees.

Why would you keep something in receivership for 20 years and pay someone to be a receiver when, obviously, very little is going to happen? I am troubled with the appearance of that, frankly.

Mr. STILLMAN. Understandably. Each time I review this with our liquidation department, I have the same reaction that you do. Happily, those three that are over 20 years old are going to be closed this year. They have $981,000 of total leverage outstanding and, happily, we will collect $627,000 of that during this year, so that it has been worth the time to hold these open.

By their nature, the assets of a venture portfolio are unmarketable, typically. In the case, for instance, of two of these there were significant amounts of real estate and unmarketable securities held which, happily, have retained some value and now finally after all these years are liquid enough to be sold.

There have not been major costs of the receivership; however, as GAO points out, when we start a receivership we are not absolutely certain as to what we are going to find there. There have been occasions, as has been pointed out, where the payoff has hardly been worth the effort, but one never knows until one starts it.

The over 20-year-old receiverships are certainly the exception to the rule. We attempt to close these out as rapidly as possible, but with unmarketable investments and with third parties that frequently have claims on these companies in receivership, it is not always within our control.

Chairwoman MEYERS. Well, I have other questions but you have all been very patient and I appreciate your being here this morning.

I don't want to give the impression that I am negative about this program. I do think that it is important that at least in the past I think it is important that we have been there for needs in the venture capital area. I want to examine very carefully whether that is still a necessity or not.

I am extremely uncomfortable with losses, as I think all of us are, and want to do everything that I can and not stoke the fire further until we are sure that the problems of the past are well-contained.

So thank you very much for being here today.

[Whereupon, at 12:25 p.m., the committee was adjourned, subject to the call of the Chair.]

APPENDIX

Statement of Chairwoman Jan Meyers
Committee on Small Business
Hearing on the SBA's
Small Business Investment Company Program

March 28, 1995

The Committee will come to order. This morning The Committee will be hearing testimony concerning the Small Business Administration's Small Business Investment Company Program. Founded by the Small Business Investment Act of 1958, SBICs are venture capital companies that use private funds supplemented with government leverage to provide financing for small businesses. The program was created as a response to a Federal Reserve report which identified a lack of long-term financing for the small business sector.

In 1972, the program was expanded with the creation of the Section 301(d) Specialized Small Business Investment Companies. These SSBICs were established specifically to help provide financing to businesses owned by socially or economically disadvantaged persons who had difficulties participating in the economic mainstream.

Today SBICs and SSBICs represent four billion dollars in a total venture capital industry that has over 37 billion dollars in assets under management. This is in contrast to 1978 when the entire venture capital industry was only three and a half billion dollars.

However, the SBIC industry has not been free of problems. Over the years a series of well publicized failures and overall difficulties have led to changes in the program. In 1991 Congress created the participating securities program, designed to provide patient capital for SBICs and cure a mismatch between financing and investments. In addition, management changes were implemented transferring auditing functions from the Inspector General's office back to the Investment Division.

Despite these efforts, problems continue to appear in the SBIC and SSBIC programs. 192 SBICs and SSBICs are in liquidation and there is roughly 523 million dollars of government leverage at risk. Last year the Committee received a GAO report documenting the misuse of an SSBIC in Arkansas by wealthy individuals connected to the White House. Today's hearing will investigate the Administration's progress in overcoming these problems and the current state of the SBIC and SSBIC programs.

NASBIC

NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
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Statement

of

William F. Dunbar

National Association of Small Business Investment Companies

before the

Committee on Small Business

United States House of Representatives

March 28, 1995

Madam Chairman and Members of the Committee:

I very much appreciate the opportunity to testify today to give my perspective on the current status and future of the SBIC program.

I am testifying today in my capacity as chairman of the National Association of Small Business Investment Companies (NASBIC), which is the national trade association for the SBIC industry.

In my professional life I am president of Allied Capital Corporation II and of Allied Investment Corporation II, a wholly-owned subsidiary which is an SBIC with $10 million in funded capital. I also serve as Executive Vice President of all the other funds managed by Allied Capital Advisers, which includes a second SBIC as well as an SSBIC.

You have asked me to focus my testimony on a number of broad issues so I will attempt to quickly address each of these.

Management of Participating Securities Program

In 1989, the SBIC industry recognized the fact that in spite of the tremendous benefits the program has generated for the U.S. economy since 1958, there were shortcomings in the operations of the program that needed to be addressed. Working closely with the SBA and with members of Congress, we helped overhaul the SBIC program, making major changes to many areas of the program.

The new, overhauled SBIC program was signed into law in September 1992 by President Bush and the regulations become effective April 1994. Included in the overhaul were many changes made to address both the cost and the risk of the program to the federal government. Also included in the overhaul was the creation of a new vehicle for small business investing which we now call the Participating Security.

We believe that the SBA has done well, given its resources, in implementing the new Participating Securities program. Their hard work is clearly reflected by the fact that 35 new SBIC licenses were issued in Fiscal Year 1994, 18 of which plan to use the new Participating Security. Eight licenses have been issued to date for Fiscal Year 1995.

All these licensees met the new, stringent guidelines of licensing as required by the regulations and the working guidelines issued by the SBA. These new licensees have sufficient private capital to operate during the years while their small business concerns are growing. These new licensees have capable, qualified management. And, these new licensees work under new, practical operating regulations that match the real world of small, entrepreneurial, growth financings.

On February 22, just a few weeks ago, the first funding of the new Participating Security allowed nine SBICs to obtain $73 million from the capital markets to invest in small businesses. This funding, coupled with private capital raised from the participating SBICs, will inject over $100 million into small business venture investments.

One SBIC executive I spoke with in Kansas, who runs one of the nine SBICs I just mentioned, is already investing his proceeds in seven early-stage companies. I stress early-stage because it is the Participating Security that permits him to provide the long-term patient capital those new companies will need to grow strong, be competitive, provide goods and services, research innovative technologies, create jobs, create wealth in their community, and generate tax revenues.

The Participating Security enables SBICs to invest in riskier, smaller businesses by deferring a portion of the interest which SBICs pay to the federal government in the earlier years of the SBIC's life. In exchange for the deferral, the government receives a participation in the profits of the SBIC, thus creating the strong possibility that the SBIC program may cost much less in the near future and may actually cost the federal government nothing–instead generating a profit for the government in the future–in addition to creating jobs, technologies, and tax dollars to enhance the U.S. economy.

The response to the new overhauled SBIC program has been nothing short of extraordinary. In the first six months after the program became effective in mid-1994, 35 new licensees were approved by the SBA, and all of the remaining appropriations in the FY 1994 budget were committed to SBICs. This year the number of license applications has dramatically outstripped both the resources of SBA to review and approve new applications and the appropriations dollars required for leverage by the new and existing SBICs.

Moreover, because the SBIC program is a matching program, roughly $1 in private capital is entering the SBIC program for every $2 matched by the federal government and the average private capital invested by each SBIC is $16 million. Thus the 35 new licensees approved in late 1994 represent roughly $500 million in new private capital entering the SBIC program, a number which far outstrips the expected supply of federal funds for the program. Adequately funded, the Participating Security program has the potential to add billions of dollars of available capital for investing in small businesses – at nominal cost to

the government, with the possibility that the program may generate a profit for the government. And the Participating Security program is just one piece of the overhauled SBIC program as the new security has also sparked renewed interest in the traditional debenture program. As a result, the debenture program also increased significantly in size and geographical coverage during the last year.

Administration's Funding Request

The overwhelming expansion of the SBIC program and of demand for leverage from the federal government has placed tremendous pressure on current appropriation levels. My response to your question about the Administration's requested funding levels for 1996 is that they are inadequate.

The funding levels needed to meet the demand by licensees, and the outcry by small businesses themselves, dramatically exceeds the current appropriations. We also recognize the current environment in which you and your colleagues in the Congress are working. We are quickly and thoroughly researching ways in which the SBIC program can operate successfully and the Federal budget can be reduced.

We, in fact, believe there are several possible ways that the costs in the federal budget might be reduced. Among the possibilities we are currently reviewing are some form of privatization. In 1967, Congress passed an amendment to the Small Business Investment

Act of 1958 that requires SBA to make "recommendation with respect to the feasibility and organization of a small business capital bank to encourage private financing of SBICs." In this current environment of fiscal restraint, we believe it is critical that we continue to explore all possible means of reducing the size of the role of the federal government and the budgetary cost to the federal government of the SBIC program--without undermining the tremendous impact the program can continue to have on the U.S. economy. We, as an industry, are committed to studying every possible means of reducing the cost of the SBIC program and the viability and effectiveness of each one.

We believe that it is possible to design a program that would reduce or eliminate the need for direct, annual appropriations while providing a consistent source of funding from the capital markets to enable SBICs to continue providing long-term patient capital for small growth companies. We hereby commit to provide you in three weeks with comprehensive and specific recommendations for fulfilling Congress' mandate in 1967 to increase the role of the private sector in the critically important SBIC program.

SBA's Management of the Program

It is my understanding that as of January 1, 1995, there were 184 operating SBICs and 94 SSBICs. There have been several licenses issued and surrendered since that time. It is also my understanding that as of January 31, 1995 there were 193 SBICs in the Office of Liquidation.

Rather than rehash projected loss figures, perhaps I can better serve the Committee by giving an SBIC practitioner's point of view as to why these SBICs may have gone into liquidation.

Perhaps these observations may also help illustrate why the <u>new</u> SBIC program is working and working very well.

- To begin, one of the first principles of finance is <u>never</u> invest in a start-up company using debt. This was a fundamental flaw with the SBIC program since its inception back in 1958. The mismatch between the interest payment obligation of the SBIC servicing its debt and the unpredictable yield from their equity investments proved to be a formula for disaster. The debenture is still a useful vehicle in the SBIC arena as reflected by the number of new licensees who plan to use debentures for investing in later stage growth companies. But it is the new Participating Security that provides the incentive and the tool to make the long-term equity investments.

• Second, insufficient working capital is another key element that would lead an SBIC to liquidation. New private capital requirements (by statute $10 million for an SBIC using Participating Securities, $2.5 million for debenture users, and $1.5 million for SSBICs) are realistic for today's operating environment. The SBIC must have sufficient working capital to sustain itself during the period before its investments begin to produce returns.

• Another crucial element of an SBIC's success is its management. SBA's adoption of a policy of a rigorous due diligence review of an SBIC's prospective management is strongly supported by the SBIC community. As a quick study done by Asset Alternatives on the first batch of newly licensed SBICs in November, 1994 notes, "On average, the managers of the new SBICs have eight years of venture capital investing experience and a total of 18 years of venture capital and related business experience." A copy of the article as published in *The Private Equity Analyst* is enclosed for the record. In short, the strength and quality of the SBIC's management is paramount to the SBIC's success.

These issues were also clearly illustrated in the Inspector General's report, "Inspection of SBIC Best Practices." We are very supportive of SBA's efforts in this area.

If time would permit, I could discuss in detail how lower leverage ratios and new valuation guidelines help prevent SBICs from going into liquidation. I could also discuss

in detail how forward commitments work to improve the funding process or how restrictions on third party debt materially improve the program. I could explain how the many technical changes to the SBIC regulation work to keep SBICs out of liquidation and investing in small businesses but I do recognize my time is limited. In short, let me say that we beleive the many fundamental changes to the program which became effective in 1994 will dramatically reduce losses in the program and the risk to the government in the future. I'd be happy to meet personally with you, Mrs. Meyers, or any member of the Committee, to discuss the impact of this exciting new program in detail.

Continuing Need for the Program

Does the SBIC program still generate real benefits? I work with entrepreneurs everyday. I can personally tell you that each investment that our SBICs make produce a real benefit. We see jobs being created on a daily basis. We see new technologies being developed and brought to market regularly. We see our portfolio company tax statements every year. Yes, Madam Chairman and members of the committee, there are real, tangible benefits produced by the SBIC program. I have encouraged each of NASBIC's members to invite their members of Congress to visit their portfolio companies. Only when you meet an employee who now has a job because their company just expanded, or just opened for business, will the perceived benefit become real.

Some have grown tired of hearing about high-profile success stories financed by SBICs such as Federal Express, Cray Research, and Intel. Yes, these valuable companies were SBIC-financed. But it is easy to overlook the tens of thousands of more mundane private companies that could only receive growth financing from SBICs. Companies like Encore Wire Corp. in McKinny, Texas, a small producer of electrical wire -- a company that was able to go public in 1992 because of a $4.1 million investment by two SBICs. Companies like Cobbleskill Diner, a small restaurant in Cobbleskill, New York, in which two SBICs invested $750,000 in 1990, starting with zero employees and growing to 45 employees with revenues of $1,250,000 in 1994. Companies like Mothers Work Inc., a retailer of maternity wear in Philadelphia in which $250,000 was invested in 1982; today the company has $90,000,000 in revenues and 113 employees. In 1990, my company, Allied Investment Corporation II, financed the acquisition by management of Williams Brothers Lumber, a tiny lumber dealer in Atlanta with 40 employees, that was being shut down by the British company that purchased its parent company. Today Williams Brothers employs over 300 people, generates over $100 million per year in sales, and pays over $1,000,000 per year in federal taxes.

These are just four companies. SBICs have invested in nearly 100,000 small businesses around the country. Some are now household names like Federal Express--most are not. Yet.

Yes, Mrs. Meyers and members of the Committee, the SBIC program produces real

benefits. Please accept the invitations by SBICs to visit their portfolio companies. You, too, will see, firsthand, the substantial benefits of the SBIC program. The need for the program identified in 1958 exists today. Then and now there is a major gap in the capital markets for long-term investing in small growth oriented businesses. That assessment holds true today.

The 1992 report of the Investment Advisory Council reported that:

- Banks and insurance companies in most regions of the U.S. have virtually ceased support to small pioneering companies, – banks provide short term working capital but not long term financing

- Private venture firms (a) suffer from the cyclical nature of their funding patterns and are not a stable source of financing (b) prefer larger deals while SBICs gravitate toward smaller financings, i.e. average deal size for SBICs is seven times smaller, (c) SBIC's disbursements are more geographically diverse, (d) SBICs are less concentrated in high technology, high growth industries, and (e) more likely to invest more in young firms in slower growth businesses.

- The public markets are not a source of capital for such businesses.

· Without question, few of the 98,000 companies financed by SBIC would have been born, would have grown or would have created the jobs created if the SBIC program was not available as a supplemental source of capital to small businesses.

Therefore in view of the successful record of growth and accomplishment in meeting the needs it was created to meet, it is time to acknowledge that a need for the program still exists.

I thank you once again for the opportunity to testify today. These subjects are of vital importance to the future of the SBIC industry and its continued ability to provide patient, long-term capital to small growing companies. We look forward to this Committee's continued oversight and support in meeting this goal. Thank you and I submit my testimony for the official record of the Committee.

THE PRIVATE EQUITY ANALYST

The Newsletter Serving Investors and Managers of Alternative Assets

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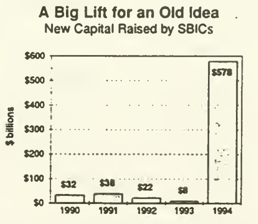
CONTENTS

First Crop of Newly Licensed SBICs Indicates Overhaul Working as Planned

Participating Securities Are a Big Hit; Institutions Still Scarce, Though

The Small Business Investment Company is back on the road to relevance.

Though it took three years to complete, the legislative and regulatory overhaul of the federally licensed venture capital program is having its intended effect. Private equity investment firms are forming SBICs in numbers not seen since the early 1960s, shortly after the program began. More money was committed to SBICs in the past nine months than in the previous 10 years *combined*.



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Since January, 35 new SBICs have raised a total of $578 million, up from an average annual rate of just $42 million during the previous 10 years. (A complete list of the new SBICs is on page 10.) If they use SBA leverage to the full extent possible, the new SBICs will add $1.8 billion to the private equity community's investment capital. That effectively is like boosting the total capital the industry will raise this year by about 15%.

"From our point of view, it's certainly been a success so far," says Robert D. Stillman, associate administrator for investment at the U.S. Small Business Administration, Washington, DC. "We're very pleased with the experience level of the managers coming into the program, and we believe they will be offering an additional source of capital to the small-business community."

Continued on page 9

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First Crop of New SBICs

Continued from page 1

An analysis by *The Private Equity Analyst* shows that many of the goals of the program overhaul are indeed on their way to being met. The analysis is based on data from the SBA and the National Association of Small Business Investment Companies, the Alexandria, VA-based trade association, and from our own data collection and interviews. The main points:

- The new "participating securities," which allow SBICs to borrow by issuing equity instruments rather than interest-bearing debentures, are a hit. So far, the SBA has licensed 18 SBICs, all in limited partnership form, that plan to use the participating securities. These 18 funds have raised a total of $373 million in private capital, which is two-thirds of all the SBIC capital raised this year.
- The rekindled enthusiasm for the SBIC program also bubbled over into the debenture-based program. Fourteen new debenture-based SBICs raised a total of $174 million, more than four times the average inflow in recent years. "The revival of interest in the traditional debenture program has been the biggest surprise to us," says Mr. Stillman.
- The new participating-security SBICs plan to invest about $4 in late-stage venture deals and buy-outs for every $1 they invest in early-stage companies, as the chart above indicates. That is actually in better balance than it might first appear, given that early-stage investments consume far less capital than late-stage investments or buy-outs.
- Half of the participating-security SBICs intend to pursue investments nationally, while the other half will follow regional strategies. The most favored regions are the Pacific Northwest, the Midwest and the Northeast. Noticeably overlooked, however, was the entire South, with the exception of a single fund based in Texas, and the Rocky Mountain region.
- If experience is any predictor of future success, the new SBICs should do well. On average, the managers of the new SBICs have eight years of venture capital investing experience and a total of 18 years of venture capital and related business experience, as the table below indicates.
- Our analysis also shows, however, that the overhauled SBIC program has yet to win acceptance among two important audiences. Very few of the better-known venture capital and private equity firms were among those who received SBIC licenses this time around. And pension funds and other large institutions were almost completely absent from the ranks of investors in the new SBICs.

The SBIC program's renewed popularity is the result of a make-over that began at the recommendation of an industry committee in 1991. The SBIC program, originally created in 1959, is widely regarded as spurring the formation of the organized venture capital industry. But the SBIC program was almost inactive by the late 1980s. Few investment firms were forming new SBICs, and the number of SBICs defaulting on their government-guaranteed borrowings was increasing.

Where SBICs Plan to Invest

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Pegged as the prime culprit was the debenture security that SBICs historically have used to borrow money. SBICs can leverage their private capital by borrowing in the public markets with the SBA guaranteeing repayment. The guarantee allows SBICs to borrow at interest rates almost as low as the rate the U.S. Treasury itself pays.

The debenture, however, required SBICs to pay quarterly interest. That obligation discouraged SBICs from making equity investments in young, growing companies, which usually lack enough cash flow to meet such current obligations.

There were other problems with the program, as well. It limited the interest rate SBICs could charge their portfolio companies. It set a $35 million ceiling

A Snapshot of the Newly Licensed SBICs
($ in millions)

	Number of SBICs	Private Capital	Avg Private Capital	Leveraged Capital*	Avg Yrs Experience Venture	Avg Yrs Experience Total
Participating Security	18	$373	$21	$1,119	9	19
Debenture SBICs	14	$174	$12	$694	6	16
Bank SBICs	3	$32	$11	$32	3	17
Total	**35**	**$578**	**$17**	**$1,844**	**8**	**18**

*Assumes 2:1 leverage for participating-security SBICs, 3:1 for debenture SBICs, and none for bank-affiliated SBICs, which generally don't use SBA leverage.

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Small Business Investment Companies Licensed in Fiscal 1994

($ in millions)

SBICs Using Participating Securities

SBIC/Location/Phone	Capital/Stage/Geographic Focus
Anthem Capital, L.P. Baltimore, MD 410-828-7292	$20.0 Balanced/Regional
Canaan SBIC, L.P. Rowayton, CT 203-855-0400	$15.0 Late-Stage/National
DFW Capital Partners, L.P. New York, NY 212-509-5580	$20.0 Early-Stage/National
Eos Partners SBIC, L.P. New York, NY 212-832-5804	$15.0 Buyouts/National
Furman Selz SBIC, Inc. New York, NY 212-309-8348	$22.5 Late-Stage/National
Kansas City Equity Partners I, L.P. Prairie Village, KS 913-649-1771	$11.0 Early-Stage/Regional
Mercury Capital, L.P. New York, NY 212-838-0888	$19.0 Late-Stage/National
MidMark Capital, L.P. C[illegible]am, NJ 201-822-2999	$20.0 Buyouts/Regional
Needham Capital SBIC, L.P. New York, NY 212-371-8300	$20.0 Late-Stage/National
Odyssey Partners SBIC, L.P. New York, NY 212-708-0641	$45.0 Late-Stage/National
Pacific Northwest Partners SBIC, L.P. Bellevue, WA 206-646-7357	$10.6 Early-Stage/Regional
Piper Jaffray Healthcare Capital, L.P. Minneapolis, MN 612-342-6335	$12.0 Balanced/Regional
RFE Investment Partners V, L.P. New Canaan, CT 203-966-2800	$45.0 Late-Stage/National
River Cities Capital Fund, L.P. Cincinnati, OH 513-621-9700	$12.0 Balanced/Regional
SBIC Partners, L.P. Ft. Worth, TX 714-729-3222	$30.0 Late-Stage/Regional
Sorrento Growth Partners I, L.P. San Diego, CA 619-452-6400	$10.8 Late-Stage/Regional
Walden-SBIC, L.P. San Francisco, CA 415-391-7225	$20.0 Early-Stage/National
Z[illegible]o Stage Capital V, L.P. [illegible]ridge, MA 617-876-5355	$25.0 Balanced/Regional

SBICs Using Debentures

SBIC/Location/Phone	Capital/Stage/Geographic Focus
Anker Capital Corp. Charleston, WV 304-344-1794	$2.5 Late-Stage/Regional
Byrd Business Investment, L.P. Nashville, TN 615-383-8673	$4.5 Late-Stage/Regional
Cordova Capital Partners L.P. Atlanta, GA 404-951-1542	$27.5 Late-Stage/Regional
Exeter Venture Lenders, L.P. New York, NY 212-872-1170	$15.0 Late-Stage/National
First Legacy Fund, Inc. Washington, DC 202-342-9090	$5.0 Late-Stage/Regional
Hanifen Imhoff Mezzanine Fund, L.P. Denver, CO 303-291-5209	$15.0 Late-Stage/Regional
KOCO Capital Company, L.P. Mt. Kisco, NY 212-397-1800	$5.0 BuyoutsNational
Maine Capital Partners, L.P. Portland, ME 207-772-1001	$6.0 Late-Stage/Regional
Pacific Mezzanine Fund, L.P. San Francisco, CA 510-930-2882	$20.0 Late-Stage/Regional
Seacoast Capital Partners, L.P. Danvers, MA 508-777-3866	$30.0 Late-Stage/Regional
Shaw Venture Partners III, L.P. Portland, OR 503-228-4884	$30.0 Early-Stage/Regional
Stratford Capital Group, Inc. Dallas, TX 214-740-7377	$5.0 Late-Stage/Regional
Wasatch Venture Corp. Salt Lake City, UT 801-328-3148	$5.5 Late-Stage/Regional
WestVen Limited Partnership Charleston, WV 304-344-1794	$2.5 Late-Stage/Regional

Non-Leveraged Bank SBICs

SBIC/Location/Phone	Capital/Stage/Geographic Focus
BancFirst Investment Corp. Oklahoma City, OK 405-270-1000	$2.5 Late-Stage/Regional
First Commerce Capital, Inc. New Orleans, LA 504-561-1491	$24.0 Late-Stage/Regional
First Security Business Investment Corp. Salt Lake City, UT 801-292-4881	$5.0 Late-Stage/Regional

First Crop of New SBICs

Continued from page 9

on the amount of SBA leverage they could borrow. And it severely restricted the size of the companies in which SBICs could invest.

The overhaul addressed these and other flaws. The legislation created an equity-like borrowing instrument — the participating security — that operates more like preferred stock rather than a debenture. SBICs can defer dividend payments on these participating securities, making it more appropriate for them to make equity investments in young companies. During the time an SBIC defers dividend payments, the SBA assumes responsibility for making them. Thus, the holder of the participating security is always receiving coupon payments on time. The SBIC later repays the SBA, which also gets a small share of profits.

The new equity leveraging feature is a big hit for several reasons. In its simplest usage, it allows an investment dollar to be stretched further.

Indeed, the equity leverage offers a solution to a common problem in regions where entrepreneurial activity is strong but risk capital is scarce.

"The participating security program allowed us to go out and raise a modest amount of capital and still have a substantial fund," says R. Glen Mayfield, a partner at **River Cities Capital Fund, L.P.**, Cincinnati. With 2:1 leverage, Mr. Mayfield notes, River Cities' $12 million fund will have $36 million in spending power.

The single biggest attraction of the equity leverage, however, is its ability to enhance the return on the private capital. If a portfolio is financed partly with private capital and partly with less-expensive capital raised at close to U.S. Treasury-rate notes, the final return on the private capital will be enhanced.

Lloyd "Buzz" Benson, managing director of **Piper Jaffrey Healthcare Capital, L.P.**, Minneapolis, estimates the SBA's equity leverage can boost the return to limited and general partners by as much as 40%. William M. Reisler, vice president of **Kansas City Equity Partners I, L.P.**, Prairie Village, KS, notes that if an unleveraged partnership earns a 25% annualized return, limited partners will see only around 17% by the time the general partners' management fees and carried interest are taken out. On the same fund, however, Mr. Reisler says, SBA equity leverage could boost the return to limiteds to 28%.

Those arguments weren't enough, however, to convince many of the better-known venture capital and private equity firms to seek licenses in the first round. While a few high-profile firms have signed on — for example, **Canaan Partners, Odyssey Partners, Inc.** and **RFE Investment Partners** — they're a distinct minority. Most of the new SBICs are either start-up or regional investment organizations.

Many established players were put off by the SBA's delay in adopting legislation. Instead of risking the possibility that the new program wouldn't gel, they raised conventional partnerships.

More well-known venture firms will likely form SBICs over the next year. For one thing, the impact on investment return almost requires it as a competitive response. If two venture firms are bidding for an investment, the one with an SBIC should always win the contest, if all else is equal. That's because the access to low-cost capital will allow the firm to bid a higher price and still achieve an acceptable investment return.

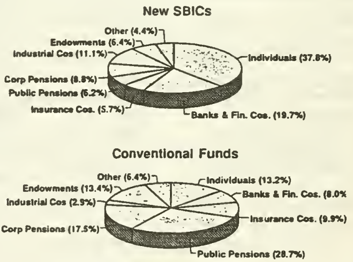
Similarly, few large institutions invested in the first crop of new SBICs, as the two pie charts below show. Conventional funds get most of their money from institutions, especially pension funds. But, individuals are providing most of the funding of SBICs, followed by banks.

There are several reasons. One is simply size. Pension funds in particular prefer to put large chunks of capital — typically a minimum of $10 million — in funds where they won't account for more than 10% of the total capitalization. This "10/10" rule makes $100 million the minimum fund size they'll consider.

Many institutions also remain dubious about participating in an investment vehicle so closely tied to government policy. And, quite simply, they have plenty of conventional private equity partnerships to keep their attention occupied.

Individuals, Local Banks Fuel Funding

Share of Total Partnership Commitments



F t Crop of Newly Licensed SBICs

Continued from page 11

The banks backing SBICs aren't the money-center banks commonly found in conventional venture capital and buy-out funds. They're not even regional banks. Rather, they tend to be medium-sized local banks that expect two benefits, aside from an attractive return. First, they expect to do more bank lending with portfolio companies and business professionals associated with the fund. And, second, investing in an SBIC helps them to meet community reinvestment requirements for federally chartered banks.

Two things will be necessary before large institutions embrace the new SBICs. First, they will need to see the leverage enhancement in action, not theory. And, second, they will need to adjust their thinking about the size of their investment relative to the size of the fund. For example, if they view a $10 million commitment in the context of the fund's entire capital — private capital plus government leverage — they can meet their 10/10 rules.

How fast the revised SBIC program grows from here is partly a question of politics. The SBA gave priority consideration to the 35 recently licensed SBICs because they had already raised their private capital. The agency has applications from another 50 candidates that intend to raise a total of about $800 million.

But, the SBA's Mr. Stillman says, the agency is nervous about licensing too many SBICs. The reason: Congress, with the budget deficit in mind, has been stingy about appropriating leverage money for the program. "We don't want to charge ahead and license so many SBICs that they won't be able to get the leverage they're looking for," Mr. Stillman says.

For the current fiscal year, which began Oct. 1, Congress slashed the appropriation for participating-security leverage to just $229 million, half of what the SBA requested. (However, the agency will be able to augment that by transferring an unused $150 million appropriation for fiscal 1994 into the current year.) The outlook for the next two years is uncertain. Congress has authorized a total of $1.55 billion in participating-security leverage for the next two fiscal years, but could cut that back during its annual appropriation process.

Whether Congress keeps that money in the pipeline will depend in part on how avidly the private equity community wants it. "One of the challenges to the industry is to make the case that we're dealing here, not with an expense program, but with an investment program," Mr. Stillman says. "We need to prove that this program repays the taxpayer" by generating payroll taxes, corporate taxes and capital gains taxes.

Testimony of

James F. Hoobler

Inspector General

of the

U.S. Small Business Administration

before

The Committee on Small Business

U.S. House of Representatives

March 28, 1995

Good morning Madam Chairman and Members of the Committee. Thank you for inviting me to appear before you this morning to discuss the Small Business Investment Company (SBIC) and Specialized Small Business Investment Company (SSBIC) programs. First, I would like to introduce my colleagues who accompany me this morning: Steve Marica, Assistant Inspector General for Investigations; Pete McClintock, Assistant Inspector General for Auditing; and Tim Cross, Assistant Inspector General for Inspection and Evaluation.

Before I summarize the related work of the Office of Inspector (OIG), I would like to make clear that my comments are largely directed to the operations of these two venture capital programs prior to the Agency's promulgation of new regulations last spring. While addressing the extent of our oversight activities relevant to these two venture capital programs, I will also cover most, if not all, the questions posed in the Chairman's March 22, 1995, letter of invitation.

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Investigations

During the past three fiscal years, the Investigations Division has conducted criminal investigations of 31 SBICs and 5 portfolio companies. During this same period of time, other allegations of fraud involving 4 SBICs and 4 portfolio companies were referred to the Federal Bureau of Investigation (FBI) due to resource constraints within the SBA/OIG. These allegations include the use of false statements to obtain Government funds, misapplication and misappropriation of funds, conversion of collateral, embezzlement, and money laundering. The potential Government losses due to fraud in these cases exceed $168 million. Interestingly, these investigations have been almost equally divided between the two programs -- 23 SBICs and 21 SSBICs.

As a result of these investigations, 11 investment company officials and associates and 1 portfolio company owner have been convicted of various criminal statutes, and over $54 million has been returned to the Government through court-ordered restitution, fines, savings, and other recoveries. There have also been some Administrative sanctions, i.e., three investment companies have been removed from the program, one

denied additional leverage, and one other which voluntarily surrendered its license. Twenty of the these 44 investigations are still on-going.

The majority of cases involving SBICs are initiated by referrals from SBA employees. Of 54 referrals since 1988, 34 were generated by SBA officials: 10 from the Investment Division's Office of Operations, 10 from the General Counsel's Office of SBIC Litigation, 8 from the OIG's Auditing Division, and 6 from the Investment Division's Office of Examinations. The remaining referrals came from other law enforcement agencies (7), private citizens (6), lenders (3), U.S. Attorneys' offices (2), and media sources (2).

It is disturbing that well over half of the referrals involving SBICs are received from outside the Agency or from the Agency offices that are responsible for their liquidation. This situation indicates fraudulent activity goes undetected by program officials until either all the funds are expended or owners of portfolio companies lose their investments. Certainly, earlier recognition by the Investment Division would help in our efforts to deter such fraudulent activity. In an effort to correct this situation, the OIG has been working closely with the Investment

Division's Office of SBIC Examinations to resolve this fraud reporting problem. For example, last year, the OIG's Investigations Division developed and presented a Fraud Awareness Training Course to the Investment Division's examinations staff. This course was designed to identify those fraud indicators which have been discovered over the course of our investigations. This training was well attended by the examiners, and we are optimistic that the information they received will assist them in improving the quality and timeliness of their referrals to the Inspector General.

SBIC Best Practices

Consistent with the administration's emphasis on identifying and encouraging good program operations throughout Government, my Inspection and Evaluation Division recently concluded a study of SBIC "Best Practices." Our goal was to identify common denominators of success that might be resident in the most successful investment companies, for the purpose of possible replication in those companies that still were struggling to become profitable. Our August 1994 report identified seven factors common to financially successful SBICs. Based

on case studies of nine SBICs, including two SSBICs, the study, not surprisingly, documented that profitable SBICs:

- are headed by managers who are well-qualified in terms of their work experience and academic backgrounds;
- offer compensation packages and intangible benefits sufficient to attract and retain high-quality personnel;
- are adequately capitalized and follow good cash management principles;
- adopt investment strategies that generally minimize risk;
- employ a systematic approach to identify, evaluate, and structure investment deals;
- monitor closely the financial health of their portfolio companies to protect their interests; and

- provide needed financing and technical assistance to their portfolio companies, thereby increasing their net worth.

Our findings also revealed that failures of SBICs are largely attributable to: (1) deficiencies in SBIC managers' qualifications, practices, and integrity; and (2) the lack of adequate private capital to sustain the SBICs. I believe that the Agency's new regulations will, over time, serve to reduce the SBIC/SSBIC failure rate. The regulations now require licensees to demonstrate that their management has the knowledge, experience, and capability necessary for investing in the types of businesses contemplated.

The new regulations do not alter the basic private capital requirements. Current regulations require regular SBIC licensees to have a minimum private capital of $2.5 million; SSBIC licensees must have a minimum of $1.5 million. If the SBICs are using the new participating securities, however, the new regulations set a minimum capital threshold of $10 million and $5 million for those applicants who can otherwise demonstrate financial viability.

In conjunction with the imposition of new licensing standards and the retention of strong capital requirements, the program office should also emphasize the need for good management practices among all their investment companies. I have recommended to the Agency's policy officials that the Investment Division disseminate, to all its licensees, a summary of "best practices," as reported by my office, to be used as a model for operating a profitable SBIC. In my judgment, the Investment Division should also require that both its operations and examinations staffs assess the presence of these "best practices" as part of their respective program monitoring activities.

Measuring SBIC Program Effectiveness

I believe that the key to assessing the effectiveness of the SBIC program is to determine the impact the SBICs have had on the growth of their portfolio companies. This may be a difficult task; however, useful measures of success would be the number of jobs, revenues, and taxes generated. The Agency's new regulations do, in fact, require SBICs to assess and report annually the economic impact of each financing according to such acceptable measures of performance. In my judgment, this is a major step forward.

In the OIG's "Best Practices" inspection, we suggested that the Investment Division work to assure comparability in economic impact data by developing specific guidance for SBICs to use in collecting and reporting such data. We also suggested that the Division require SBICs to specify, in their annual impact reports, the dollar amount of each financing **in proportion to other sources of financing received by the portfolio company**. In this way, the SBA would be able to estimate, more accurately, the extent of the SBICs' impact on the economy. Only rarely do SBICs serve as the sole source of financing to their portfolio companies. In our limited study of the impact that 9 SBICs had on 17 portfolio companies, we found that these companies had received, on average, only 21 percent of their financing from the SBICs.

Auditing Activities

Since the October 1, 1992, transfer of the SBIC/SSBIC examinations function from the OIG to the Investment Division, the OIG's Auditing Division has substantially reduced its auditing activities of these two programs. Our auditing focus has appropriately shifted to the balance of the Agency's activities, especially the 7(a) loan program and the 8(a) minority enterprise development program -- both of which had

previously received little oversight by the OIG. I would note, however, that the **OIG Planning Guidance for FY 1995-1997**, copies of which have been given to the Committee, calls for an internal audit of the Investment Division's examinations function by the close of FY 1997.

The OIG's main SBIC/SSBIC audit activity over the past three years has consisted of two audits: (1) an audit of SBIC liquidation activities; and (2) an audit of a proposed merger of three SSBICs, involving the SSBIC preferred stock buyback program.

The liquidation audit reviewed the adequacy of procedures for controlling and liquidating assets acquired from failed SBICs, or from SBICs that were in the process of going out of business. The audit found the following deficiencies in the Agency's stewardship of the program: (1) outdated policy guidance; (2) significant differences between the written procedures and actual operations; (3) little or no evaluation of the fair market value of acquired assets; (4) a lack of required liquidation plans; (5) delays in the transfer of financially-troubled SBICs/SSBICs for liquidation, which, in turn, reduced recoveries of Government funds; (6) delays in closing receiverships which resulted in

reduced recoveries; (7) a failure to report some settlement agreements as compromises, so they would be reviewed by SBA's compromise committee; and (8) a need for better controls over assets. In response to the audit, the Agency's Associate Administrator for Investment generally agreed with the OIG's recommendations. Records maintained by the Agency's audit follow up system show that our recommendations were implemented.

The audit of a proposed SSBIC merger of three SSBICs was conducted in response to an anonymous complaint that the merger would violate regulations and would result in losses to the Government because the surviving company would be able to participate in the SSBIC's preferred stock buyback program. We concluded that the approval of the merger precluded SBA's ability to recoup most of the $3.8 million in preferred stock and dividends in arrears, i.e., from an inactive SSBIC which had the ability to repay SBA in full.

One of the three SSBICs, with $9.4 million in SBA leverage, requested SBA's approval to establish a holding company and to subsequently merge with two other SSBICs. The second SSBIC, with

$2.7 million in SBA leverage, had been inactive since 1988 and had indicated a desire to leave the program. The third SSBIC, with $1.5 million in SBA leverage, was capitally impaired and had also indicated a desire to leave the program.

As part of the merger, the first company planned to distribute $450,000 of its private capital to a holding company, contrary to the Small Business Investment Act requirement that, prior to any distribution, all accumulated dividends be repaid. SBA's Acting General Counsel interpreted the law to pertain only to distributions from retained earnings, not from private capital. Three other regulations were waived to permit the merger.

The Agency believed the merger was in the best interests of the program because the decision kept the three firms' resources available for investment in small business, and the merged company could raise an additional $3 million over the next five years. If, on the other hand, the two inactive companies were liquidated, the $3.8 million would have been deposited in the Treasury and the funds would not have been available for small business investments. Based on past historical

growth in private capital, the OIG calculated that only $735,000 would be added to the private capital of the SSBIC, at a cost of $2.8 million to the taxpayers. This equates to the amount owed to the Government which would be lost if the merged company was allowed to participate in the preferred stock buyback program.

During the audit, the merger was approved by the then Associate Administrator for Investment rendering some of our recommendations moot. Therefore, the OIG recommended that the Government reduce its potential loss by not allowing the merged company to repurchase preferred stock at a discount. SBA's senior management rejected our recommendation to prohibit any discounted buyback of the SSBICs' preferred stock.

The Investment Division decided that the buyback was integral to the merger and that the merger would keep needed capital in the program. In short, the two SSBICs would have found themselves in liquidation if they had been required to use their cash to repay the preferred stock and dividends in full, thereby reducing available capital and incurring liquidation costs.

The Investment Division subsequently published a Notice setting forth these same guidelines for the stock repurchase program; that is, all future mergers would also be approved using these guidelines. The OIG disagreed with the Division's position. Approval of the merger allowed the owners of these companies to avoid taking a loss on the sale of their SSBICs. Instead, the loss will be transferred to the taxpayers, should a discounted buyback occur. Not only did the OIG disagree with the particular merger, but we also opposed implementation of the guidelines which would trigger recurrences.

In August 1990, the OIG began a formal program of reviewing the quality of independent CPAs who certified financial statements for SBICs/SSBICs. We reviewed the audit reports and notified the responsible CPAs of any variances from generally accepted auditing standards (GAAS). We also selected a sample of SBIC/SSBIC audits to review the work their CPAs had conducted in support of their audit reports.

During the three and a half years the OIG's Auditing Division reviewed CPA audits of SBICs/SSBICs, about 35 percent of the reports

required a major change to comply with GAAS standards. In most cases, the CPAs cooperated with our findings and corrected their reports. The OIG also made 17 referrals to State licensing boards involving substandard work or CPAs performing work in States where they were not licensed to do so. Lastly, one CPA review caught one licensee which had submitted forged certified statements. I am pleased to report that the licensee was subsequently removed from the program.

As noted earlier, this CPA review program was active through January 1994, but it had to be discontinued by the Auditing Division due to the lack of staff resources and higher audit oversight priorities.

Material Weakness in Need of Correction

In 1990, in response to an Auditing Division examination report that questioned the disadvantaged status of recipients of SSBIC financings, SBA's Office of General Counsel concluded that the regulations governing "disadvantaged" concerns were unenforceable. The OIG agreed and recommended that an enforceable definition be established. While the former Associate Administrator agreed to do so, revised criteria clarifying economic disadvantage have not been issued to date.

In FY 1993, the OIG's Investigations Division prepared, and I issued, a program vulnerability memorandum (PVM) which asked the General Counsel to draft changes to the definition of eligibility in section 301(d) of the Small Business Investment Act of 1958 to include both social and economic disadvantage with respect to the controlling owners of SSBIC portfolio companies. The PVM was developed from an OIG investigation of an SSBIC, wherein a number of portfolio company owners had a net worth between $1 million and $64 million. The SSBIC took the position that the companies were eligible for financing, regardless of their wealth, because their principals were members of a designated disadvantaged group. The PVM also pointed out the contrast between the vague criteria used by the SSBIC program and the much clearer criteria applied by the Agency's Section 8(a) program.

On September 30, 1993, the former Associate Administrator for Investment requested that the General Counsel draft appropriate legislative changes, which would establish criteria for use in determining social and economic disadvantage. At the time, he said it was his desire to address this long-standing program vulnerability.

On June 22, 1994, the current Associate Administrator for Investment issued a memorandum to all SSBICs advising them that the Agency was indeed reviewing the eligibility criteria. In the interim, the SSBICs were told that members of groups specified in 13 CFR 124.105(b) would be assumed to be socially disadvantaged and no further information, including financial status, would be considered. While we have been told that program officials have considered additional eligibility criteria, none has been forthcoming.

The OIG continues to take the position that public confidence in the SSBIC program would be increased by tightening the "disadvantaged" criterion. If the current practice is allowed to continue, some millionaires will surely remain classified as "disadvantaged" individuals.

<u>Comments on Proposed Regulations</u>

The OIG is responsible for reviewing proposed regulations and making recommendations concerning the impact of the regulations on program operations. The OIG has reviewed several SBIC/SSBIC

regulations in the past two years. I will provide a synopsis of our comments where OIG recommendations were not fully implemented.

The Agency proposed a regulation permitting an SBIC to finance real estate by a small business, if the property owner was an alter ego of the small business and the business is the sole occupant of the property under lease. The OIG disagreed because we were not convinced that permitting SBIC real estate financing was appropriate public policy. There are more appropriate sources for such financing, including two within SBA, i.e., the guaranteed loan and development company programs. Obviously, the diversion of venture capital into mortgages results in less startup funds for small businesses. Also, funding real estate is a passive business activity, historically considered contrary to the purposes of the program. Lastly, the primary economic benefit accrues to the property owner, not to the small business. While the regulation has never been adopted, I understand that such real estate financing is still being permitted in practice by the Investment Division.

Another proposed revision set guidelines for issuing SBA guaranteed participating securities. We expressed concern because the

proposal raised capital impairment levels significantly. Generally, capital impairment occurs when more than the allowable percentage of the SBIC's private capital is lost; a high impairment usually indicates poor financial condition, or possibly a near term default. Under the original proposal, during the first six years following issuance of participating securities, the licensee, under some circumstances, was not considered impaired unless he reached the 100 percent impairment level. Also, unrealized appreciation on investments was included in the computation. SBICs that are not capitally impaired can receive additional leverage, thus increasing SBA's exposure. The OIG suggested that impairment levels be lowered to protect the Government's interests. Under some circumstances, it was lowered to 85 percent during the first four years. While this is better than the 100 percent proposed, it is, in my judgment, still too high.

Finally, the OIG reviewed proposed clarifications to the <u>preferred stock buyback program</u> that permitted, under specially-defined circumstances, the stock to be repurchased with "idle funds" of the company. We again expressed our view that the program appeared overly generous and the clarification would allow an SSBIC that

appeared to be financially healthy, i.e., no debt; a large cash position; and possession of unencumbered, publicly traded marketable securities with realizable gain, to participate in the repurchase program to the detriment of the taxpayer. Notwithstanding our objections, the clarification was issued.

Thank you Madam Chairman. This concludes my formal remarks. While I believe I have answered the questions you posed in your letter of invitation, my colleagues and I will be pleased to address any other questions you or the other Committee Members may have regarding the work of the OIG, as it pertains to the SBIC or SSBIC programs.

NAIC

Testimony of

Terry L. Jones, Chairman

National Association of Investment Companies

Before the
Committee on Small Business
U.S. House of Representatives

March 28, 1995

Statement of Terry Jones

Good morning, Madam Chairman and Members of the Committee. I am Terry Jones, Chairman of the National Association of Investment Companies ("NAIC"), the industry association for venture capital firms that dedicate their financial resources to investment in minority-owned businesses. I am also President of Syndicated Communications Capital Corporation ("SYNCOM"), a Specialized Small Business Investment Company licensee of the U.S. Small Business Administration ("SBA"), and General Partner of Syndicated Communications Venture Partners, L.P., a private equity partnership funded by some of the largest pension funds in the country.

The members of NAIC include privately-owned specialized small business investment companies ("SSBICs") licensed and regulated by the U.S. Small Business Administration ("SBA"), privately-owned venture capital firms which manage investment partnerships ("private equity funds") and quasi-private investment companies chartered by state and local governments for the purpose of minority-focused investing. On behalf of NAIC, I am pleased to have the opportunity to discuss with you today focused, small business investing and the SSBIC program.

Your letter of invitation asked me to consider a number of specific issues with respect to the SSBIC program such as financial returns, budget issues and SBA program management. These are very important issues which we think must be discussed in their proper context. Madam Chairman, we think it is absolutely critical that the Committee, the Congress, the SBA, and its licensees, have an honest conversation about this topic.

Efforts to Revitalize the SSBIC Industry

Over the past two years, there have been few meaningful efforts by the SBA that I could characterize as revitalizing or working with the SSBIC industry. Given our industry's success at achieving the public policy goals implicit in the mandate set forth in Section 301(d) of the Small Business Act of 1958, as amended, one might assume that the SBA would take great satisfaction in our program and act to facilitate our further success. Indeed, one would think that the Agency would establish an agenda to facilitate the flow of capital into our marketplace and ensure a friendly, stable regulatory environment within which the industry could raise and invest capital. Unfortunately, just the opposite has often been the case.

First and foremost, SBA's fundamental support of the Specialized SBIC industry is subject to question, particularly in view of the significant emphasis and priority they have placed on the Non-Specialized SBIC industry. This is evidenced by the Agency's low level of funding for the SSBICs, by its arbitrary development of polices, and by its often unfriendly day-to-day management of the program.

An example of the low level of support given the SSBIC industry by SBA was illustrated in the FY 1995 budget request presented before this Committee by SBA Administrator Erskine Bowles last year. This budget request completely eliminated the most important type of funding for Specialized SBICs, preferred stock, while simultaneously requesting $500 million in similar funding for regular SBICs. When questioned by a Member of this Committee about the proposed elimination of preferred stock, Administrator Bowles replied that he was putting his limited resources where he believed they would do the most good. His message was clear, and

one can hardly fault private investors for questioning the future availability of preferred stock and debt leverage, the single most important factor stimulating private capital into the industry.

Lack of Agency Support

The Agency's indifference or disregard for the SSBIC program is demonstrated not only through its frequent development of injurious regulations and arbitrary policies, but also through the Agency's failure or refusal to implement Congressional mandates regarding SSBICs. For example, in 1989, Public Law 101-162 was enacted and provided for SSBICs to repurchase their 3% preferred stock from the SBA. This was an important opportunity for SSBICs to restructure their balance sheets in order to attract additional private capital. After five years and numerous delays, the SBA finally issued regulations and launched this important recapitalization program, which has still run into implementation complications. Conversely, the much more complicated recapitalization program for regular SBICs, and the creation of a new financial instrument (participating securities) was accomplished in less than two years after statutory enactment.

Other examples of burdensome policies include the Agency's establishment of new minimum capital standards which greatly exceed the capitalization of 91% of the SSBIC industry, restrictions on third party debt, and a new requirement that, in order to obtain leverage, all companies must agree in advance to the SBA's ability to remove officers, directors, or general partners and to appoint SBA or its designee as receiver of the Licensee upon the occurrence of a number of violations, some of which are open to wide and subjective interpretation.

However, I would be remiss if I did not mention at least one or two positive efforts undertaken by SBA in support of the program. First, the appointment of Robert Stillman as Associate Administrator of SBA's Investment Division, and Cassandra Pulley as Deputy Administrator, have given our industry a ray of hope that program improvements may be in the pipeline. Establishment of the SSBIC Advisory Council, ostensibly to review and recommend improvements in the program, is another positive step in the right direction. But after just one meeting of the Council in January, SBA has not scheduled any subsequent meetings, suggesting to our industry that our issues may once again be neglected.

How SBA Can Improve the Program?

Provide Reasonable Statutory Interpretation

Regarding how SBA can improve the program, one simple adjustment could be a fair interpretation of Congressional mandates. For example, in 1992, Congress enacted Public Law 102-366, the Small Business Credit and Business Opportunity Enhancement Act of 1992. Section 413(2) of the Act amends 15 U.S.C. §683(e), by setting forth an exception to the general rule governing the status of public funds invested in a section 301(d) licensee (SSBIC). This exception provided by Congress allows section 301(d) licensees to include in private capital for any purpose, funds indirectly obtained from State or local governments. While the statutory language in another section of the Act specifically limits direct investment of public funds in all SBICs to 33 percent, no such limitation, express or implied, was established for funds indirectly received by SSBICs.

In response to a letter from the Honorable Kweisi Mfume in 1993 seeking clarification of SBA's interpretation of this provision, Administrator Bowles acknowledged that subject to two conditions being met, "we [SBA] would permit up to 100% of an SSBICs private capital to be from indirect state and local government sources". Since Mr. Bowles' departure in 1994, the SBA has apparently reconsidered its position and has now adopted a distinctly different interpretation of the statute creating a standard for "indirect" funds which is all but impossible to overcome for state government investment in an SSBIC. Not only is the newly created standard onerous, but it is difficult even for SBA to articulate as a policy. In fact, NAIC would appreciate this Committee requesting clarification from SBA on this specific policy.

Regulatory Relief

With regard to the regulatory process, we understand that the SBA exercises administrative discretion whenever it perceives the freedom and ability to choose among possible courses of action. In the case of the SSBIC industry, the course of action often chosen leads to the inevitable conclusion that there is strong distrust for SSBIC managers, upon whom program's success ultimately depends. Regulations that restrict and control the investment managers' ability to make good business decisions diminishes the capacity for creativity and capability to respond to the changes in the marketplace. To be successful in the venture capital industry, the investment managers must maintain sufficient flexibility to execute their business plans in a prudent, businesslike fashion. Unnecessary constraints on the licensees reduces their viability, and therefore also reduces the potential return to the government and the other investors. Madam Chairman, relaxing the regulatory burden for 301(d) licensees is consistent

with good business practices, and is also compatible with the Republican party's business philosophy.

Secondary Market Access

Another positive improvement in the SSBIC program which could be easily implemented by SBA would be to make secondary markets accessible to SSBICs by permitting them to qualify as participants in SBA's 7(a) guarantee loan program. This would be particularly beneficial to debt-oriented SSBICs. By selling the guaranteed portion of SBA loans in the secondary market, SSBICs could generate a much larger dollar volume of overall lending than would be possible utilizing only their own capital and SBA leverage. Liquidity would be enhanced, and more loan dollars would flow to small business enterprises. In this regard, NAIC has initiated discussions with SBA to institute a pilot program allowing debt-oriented SSBICs to establish a separate corporate entity that would be authorized to participate in the 7(a) loan guarantee program. Encouragement by this Committee may speed the process along.

Liquidity could also be enhanced by another improvement in the program that would permit SSBICs to devote some percentage of their assets to short-term debt forms such as revolving credit lines. Current requirements of the program restrict debt investments to not less than four years, thereby eliminating many potential short-term loan opportunities. This may require a statutory change, but any change that permits some flexibility in the term of investment, without compromising safety and soundness, would be extremely beneficial to not only the SSBIC licensees but also to the companies in which they invest. The demand for these

types of loans are indeed significant and being in a position to capitalize on this opportunity could give greater assurance of a more secure return to the government.

SSBIC Advisory Council

One final suggestion regarding efforts that can be undertaken by SBA to improve the SSBIC program would be to focus greater attention on advancing the fundamental mission of the SSBIC Advisory Council. An extensive review of the SSBIC program with recommendations for improvements is the mission of the SSBIC Advisory Council. The comprehensive review of the SSBIC envisioned by the Council's mission would not only enable a meaningful self-examination by all parties, but would ultimately result in recommendations that could benefit Congress and this Committee in particular as you continue your own review of SBA programs. We are confident that a vigilant review of the program will demonstrate just how successful the program has been and the potential for greater success which could result from a few minor reforms.

Administration's FY 1996 Budget

In regard to the SBA's Fiscal Year 1996 budget request for SSBICs, the industry is obviously disappointed that only $15 million was requested both for direct funding for preferred stock and guaranteed funding for debenture leverage. This low level of funding must be examined in the context of total leverage provided in prior years. The appropriation level for the SSBIC program was decreased from $48 million in FY 1994 to approximately $32 million in FY 1995, and it has been further decreased to $30 million for FY 1996. Assuming this amount is

appropriated, it is incapable of fulfilling the estimated $50 expected to be requested for leverage from new and existing licensees.

Is the Program Still Necessary?

As it was in 1969 when President Nixon first called for a targeted capital formation initiative, access to capital is an ever present obstacle to small business development. In an interim report to Congress by the U.S. Commission on Minority Business Development in 1990, lack of access to capital was cited as the single most important variable affecting the start-up, growth, and maturation of minority business. The Commission's final report in 1992 stated that "access to capital and credit for minorities in business is at the heart of resolving many problems in America, economic and social". The report recommended, moreover, that the President and the Congress promote long-term "risk" investing for minority and small business concerns. Federal policies must be crafted to address the realities of the 1990s if these businesses are to overcome social or economic disadvantages and help the nation achieve the goal of "a well balanced national economy" as called for in the Section 301(d) of the Small Business Investment Act of 1958 as amended.

Your letter to me posed the question--"Is the SSBIC program still necessary?" Perhaps another way of stating this is "is it in the national interest to promote and provide incentives to facilitate the flow of private investment capital toward small business concerns owned by socially or economically disadvantaged entrepreneurs?" In answering this question we first need to determine whether the program promotes the public good, and if it is successful and cost effective. In a preamble to the report of the U.S. Commission on Minority Business

Development, in 1992, President George Bush wrote, "Minority business men and women have always demonstrated the kind of commitment to excellence that is vital to keeping America strong and competitive. Time and again, minority entrepreneurs have demonstrated the power of individual initiative and private enterprise, reaffirming our conviction that freedom and opportunity are the key to success for individuals and nations."

Program Success

I can assure you that my colleagues and I spend long hours efficiently directing capital into the most viable opportunities, providing support for the businesses in which the capital is invested, and maximizing the return to the providers of private capital. Many of us have been involved in the industry since the initial inception of the SSBIC program, which was codified by amendments to the Small Business Investment Company Act of 1958, as amended in 1972. We are proud of our accomplishments and are all the more wiser from our mistakes. We believe the SSBIC industry has been a success and can continue to make significant contributions to minority and small business enterprise development if it is allowed to operate in accordance with the realities of today's business environment.

Already, we have nurtured a significant number of small businesses which are now profitable enterprises. Over the last 20 years, in excess of over $1.6 billion has been invested in over 16,000 companies. These investments have helped create or sustain over 160,000 jobs, chiefly in the minority community. Tax payments by licensees and their portfolio companies are well in excess of federal leverage, not to mention the income taxes paid by employees. Our

ability to accomplish even more has been constrained only by a lack of capital, and, all too often, an unreliable and unpredictable partner, the SBA.

Pension Funds Recognize Opportunity

One major trend is developing which perhaps best exemplifies just how successful the SSBIC program has been, despite its shortcomings. After 25 years of operation, the Specialized SBIC industry has attracted private capital estimated at just under $200 million. Significantly, during the past year alone, pension funds and other institutional investors have committed more than $550 million in venture capital firms that focus investments activity on minority entrepreneurs. Although these pension funds and other institutional investors are investing in partnerships that are often managed by current and former SSBIC executives, the investment vehicles themselves are not SSBICs. I submit that the institutional investors that place their capital into these partnerships have carefully evaluated the marketplace and have determined that the need and investment opportunities in this arena are indeed compelling.

History

Madam Chairman, the SSBIC program was in part created in response to the widespread urban unrest of the late 1960's. The Kerner Commission investigated civil disorder in the inner cities which revealed that in the area of Federal government assistance to small business, there were virtually two societies, "one black and one white ... separate and unequal". Consequently, the Commission recommended that the Government encourage business ownership by minorities. In a statement to Congress, President Nixon urged enactment of a minority enterprise

small business investment program to attract and aggregate capital "to fill the need for minority enterprise high risk capital". President Nixon viewed this effort in terms of targeted capital formation, and as a component of a "Black Capitalism" strategy to develop these businesses.

Over the years, the Minority Enterprise Small Business Investment program proposed by President Nixon has drifted from the original goal of capital formation. Subsequent policies embodied in the program were predicated on a limited vision of provisional support for extremely small firms, engaged generally in a narrow line of business activity, concentrated in service industries, located principally in urban communities serving primarily a minority clientele. Conflicts between investment companes and SBA arose from the program's early beginnings over how public policy would be translated into operating investment companies. There was much criticism at first for companies not investing money fast enough. The program was viewed by many as having a social orientation. As a result of increased pressure to put money out quickly, some extremely high risk deals were encouraged and many of those companies failed. It took a few years for the SBA and the industry to come to the realization that the program needed to be viewed in the context of a for-profit activity.

Even today, the issue of how much money the licensees should be allowed to make still surfaces. The message then, and now, seems to be that it is okay for SSBICs to receive a return on their investments, but that return should not be too high. The irony is that the healthier the industry is, the more road blocks SBA regulators seem inclined to erect. This deterrent mentality even extends to the treatment to SSBIC investment managers. SBA wants to see improvements in SSBIC management, and yet they insist on approving and limiting managers' salaries. The

extreme difficulty in attracting experienced and talented managers if there is no upside for their labor, should be obvious.

Notwithstanding detrimental program administration issues, the business community of the 1990s is profoundly different than it was twenty-five years ago. There is a great deal of diversity among and within industries, and today's entrepreneurs are highly educated and motivated. In order for the SSBIC program to create strong and growing companies, create jobs in disadvantaged communities, and increase tax revenues for the nation's economy, it must be allowed to focus on today's educated and motivated entrepreneurs who possess the resources for successfully building small businesses.

It is ironic that the characteristics which will help ensure the creation of successful companies, with attendant economic benefits, are often the very characteristics which are used by those who would oppose federal support for focused investing. That is why reasoned conversation on basic goals is so important.

The Mission

Madam Chairman, our goal is straightforward and simple, yet accomplishment of the goal continues to be a key challenge to small business development in this country. That goal is to execute a strategy for the efficient aggregation and prudent deployment of investment capital to under-served entrepreneurs, and to help build successful, strong and profitable enterprises. In carrying out this objective, we seek to increase company value, create wealth and to produce satisfactory returns for our investors and shareholders.

What flows from this mission is a basic principle that has important implications for the SSBIC program, its evaluation by the Congress and SBA's management. Under no circumstances should minority and small business focused investing be regarded as a social welfare activity. While the derivative results of our investment activity yield substantial social good such as jobs and tax revenues, these benefits stem from solid business acumen and sound economic decisions. However, at the same time it should be noted that we are company builders and serve a market that has largely been neglected by traditional financial intermediaries and the equity investment community. And importantly, we have developed a cadre of talented investment professionals who understand the marketplace and who have the demonstrated ability to identify opportunities and to structure investments to realize their full potential.

This mission can only be achieved if the program is structured and administered in a manner that will allow licensees to use good business judgement to operate their companies and provide incentives for these companies to attract new private capital. The federal government can be a powerful catalyst for private sector investment in SSBICs and private equity funds.

Conclusion

Madam Chairman, I would encourage a meaningful dialogue on these issues. Those of us who have been involved with the SSBIC program for a number of years believe strongly in the program's purpose and potential. Moving forward, let us all focus on the opportunities provided by this program, and not be distracted by the difficulties which inevitably accompany the creation of successful businesses. Let us begin an honest dialogue that results in a stronger SSBIC program. A program that enhances our ability to attract new private capital. This

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approach will allow qualified investment managers to successfully aggregate and deploy capital into enterprises which will yield long-term benefits for the nation's economy, and provide for the general welfare of the United States. Thank you again for the opportunity to share our views with you.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

TESTIMONY OF

MARY JEAN RYAN

ASSOCIATE DEPUTY ADMINISTRATOR

FOR ECONOMIC DEVELOPMENT

SMALL BUSINESS ADMINISTRATION

before the

SMALL BUSINESS COMMITTEE

UNITED STATES HOUSE OF REPRESENTATIVES

HEARING ON

THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM

March 28, 1995

Good morning Madam Chairman and Members of the Committee. I want to thank you for inviting me to appear before you this morning to review the Small Business Investment Company (SBIC) Program and the Specialized SBIC (SSBIC) Program.

In previous hearings, we discussed various financing tools offered by the U.S. Small Business Administration (SBA) to meet the diverse capital needs of America's small businesses. The hearings have examined the 7(a), 504 and Microloan programs. The SBIC program increases the availability to small businesses of equity capital and long term debt.

Accompanying me today is Bob Stillman, the SBA's Associate Administrator for Investment. Bob is a 38 year veteran of the venture capital and private investment business. When the SBIC program began in 1958 he was associated with Payson & Trask, one of the earliest organized venturing firms. As a Partner of that firm in December 1964 he was invited by the National Association of SBICs to critique the SBIC program at its annual meeting. He has followed the program with interest since then, and has welcomed the opportunity of managing its entry into a new era.

The SBA's objective in economic development is to create jobs and accelerate the growth of the economy. An important way of achieving this goal is by making capital available where private

sources alone are not providing it. To accomplish this, the SBA is a partner with private capital sources across the full range of financing needs of small businesses.

To increase the availability of equity capital and long term debt, the SBA supplements, or "leverages" the private capital of independent venture capital firms, which it licenses as SBICs.

At present there are 182 active regular SBICs and 94 Specialized SBICs (which invest only in businesses owned and controlled by persons whose ability to compete in the free enterprise system is hampered by social or economic disadvantages). These 276 firms have total private capital of $3.1 billion and $848 million of SBA-guaranteed leverage, broken down as follows:

	Number	Private Capital	Leverage	Total
SBIC	182	$2.96 billion	$564 million	$3.5 billion
SSBIC	94	$188 million	$284 million	.5 billion

Because of the aggressive steps that the Congress and the SBA have taken to improve the SBIC program, the program exemplifies the Administrator's observation that "This is not your father's SBA."

ADDITIONAL STREAMLINING

As you know, the President yesterday announced additional comprehensive measures to streamline the SBA. Among these measures

will be an examination of the feasibility of further privitizing the SBIC and the SSBIC programs.

The mechanism for providing funding of SBIC and SSBIC leverage was privatized in 1986, when the SBA replaced direct government funding with a program of guaranteeing debentures sold to private investors. To study the possibility of privatizing the remainder of the program, the SBA has organized a working group of technical experts and plans to appoint a Council of knowledgeable private sector representatives to review their recommendations.

We expect that very soon we will know if the SBA can propose a privatization of the program that will: reduce or eliminate the need for a budget authorization for the SBIC program; provide a means for continued financing of the leverage offered to SBICs and SSBICs, and; assure continued oversight of the program. Any plan to privatize these programs also must take account the needs of the small business community, including those in regions of the country that are not served by the private venture capital industry.

BACKGROUND

Since 1958, the SBA has increased the availability of equity capital and long term debt to many small businesses by supplementing, or "leveraging" the private capital of SBICs.

SBICs are private investment companies which are managed by experienced investors and represent significant amounts of private capital. Their sole activity is making debt or equity investments in small businesses, putting their private capital at risk ahead of any funds obtained through SBA.

SBICs fill a gap in available financing sources for small business. Most private venture capital firms are now so large that they are unwilling to make investments of less than several million dollars each. SBICs are generally smaller than private investment firms, and therefore make smaller investments; in addition, SBICs are limited by statute and regulation to invest only in small companies. Furthermore, the SBA gives highest priority to license applications from parts of the country that are underserved by venture capital and those that will finance new businesses.

Since the inception of the program, SBICs and SSBICs have invested nearly $12 billion in approximately 77,000 small businesses, including close to $1 billion in fiscal year 1994 alone. Regular SBICs have financed approximately 60,000 small businesses, while SSBICs have financed approximately 17,000 small business concerns. An independent council has estimated that these investments have created more than a million new jobs.

Some SBICs invest in the equity or other permanent capital of small concerns, while others make long term loans, often with some

equity rights. These "lender" SBICs provide capital for businesses which do not offer the "home run" potential of later selling stock to the public, or companies whose owners do not want other shareholders. This type of financing is not available from banks or private venture investors.

The role of the SBA in the program is to determine which SBICs to license, to oversee and regulate those licensees, and to arrange for government-guaranteed financing from private sources to add to their capital. The cost of the program to the government is only a small fraction of the leverage provided, representing a provision for future losses.

In addition to investing or lending, the SBIC managements add value to the small businesses in which they invest by providing advice and counsel to them. Entrepreneurs will accept this help, since it comes from people who have their own money and reputations at risk in the business and who have had experience with similar situations in other companies they have backed. A significant criterion for licensing during the past year has been the SBA's assessment of the ability of the proposed SBIC management to offer this kind of support.

A number of major U.S. companies trace their early financing to SBICs, including Apple Computer, Federal Express, and Intel Corporation, and more recently, America On Line, Sun Microsystems,

Sybase, Inc., Callaway Golf, and Outback Steak House, as well as thousands of other small concerns throughout the Nation.

Private capital and private management are the foundation of the SBIC program, and since 1986 the funding of leverage provided under the program has come from private sources as well:

- SBICs are managed by private venture investors, who make all investment decisions within the broad parameters allowed by SBIC Regulations.

- Private capital is always at risk in its entirety ahead of SBA leverage.

- Funds for leverage are provided through the public sale of trust certificates, guaranteed as to interest and principal by the SBA.

IMPROVING UPON THE PUBLIC/PRIVATE PARTNERSHIP: THE PARTICIPATING SECURITY

In April 1994, the SBA issued final regulations implementing the provisions of the Small Business Equity Enhancement Act of 1992. These new regulations incorporate the best practices of the private venture capital community, as well as the past experience of the SBIC program. The result has been an enormous strengthening

of the program. This complete overhaul of the program corrected the weaknesses that had led to well publicized problems of the past.

Until April, 1994, all leverage provided by the SBA to SBICs came in the form of loans which were made to them by private lenders, and guaranteed as to payment of principal and interest by the SBA. The SBA arranges these financings in public offerings of guaranteed certificates backed by pools of SBIC debentures which are made quarterly.

For those SBIC licensees which typically make loans, with or without equity features, this debt financing represents a well-matched form of leverage. They are receiving interest income from their loans, which they can apply immediately to the payment of interest they owe. The debt financing, however, is a mis-match for the needs of an SBIC that invests heavily in equity securities, which might increase substantially in value over time, but which do not generate immediate cash for distribution to the SBIC to pay interest or principal.

A major achievement of the new program has been the creation of a second form of leverage, designed specifically for equity investors. The new leverage is called the "participating security," which is used by the SBA to invest in the capital of SBICs. This is "patient capital," which has a return ahead of

other investors, and offers the SBA a participation in profits. Actual cash payment of the cost of the leverage, however, is deferred until equity investments have matured and profits have been generated.

As with the debenture program, actual funds used for the purchase of participating securities are borrowed from private investors in periodic offerings in which principal and interest are guaranteed by the SBA.

In response to the new regulations, 43 new SBICs have been licensed in fiscal year 1994 and 1995, representing approximately $700 million of private capital. An additional 61 applications are on hand, representing another $900 million, while 28 have been denied or withdrawn. The new licensees meet the tough requirements of the new regulations:

- All have been carefully screened, especially for quality and experience of management.

  They have been licensed to use the form of leverage which best matches their investment programs: for those which make loans, and have interest income, the SBA offers the traditional debt leverage. For those making equity investments, the SBA uses the new Participating Security.

- Individual new SBICs have private capital averaging $15 million each, compared with an average of $2.4 million for those licensed in fiscal year 1992. A larger capital base allows the company to secure stronger management, and to have greater diversification of its investments.

A total of 24 SBICs have been licensed to use the participating security, including 23 of the new licensees and one existing licensee. These 24 licensees have private capital of $386.2 million, or an average of $16 million each.

We have on hand 30 additional applications for SBIC licenses contemplating use of participating securities, including 13 that already have committed private capital of $198 million. The remaining 17 applicants are in various stages of raising their private capital, which is estimated at an additional $281 million.

The first open market financing of $73.3 million of securities to provide participating security leverage closed on February 22, 1995.

The new program has stimulated additional interest in debenture leverage as well. During fiscal year 1994 and 1995 to date, we have licensed 15 new SBICs which will use debentures. Their private capital totals $175 million.

The new licensees have just the characteristics the SBA had hoped to attract: experienced managers backed by strong financing with constructive business plans. Attached is a brief description of each of the new SBICs, with an indication of the experience of each.

Because almost all of the leverage funds in the SBIC program are secured from open market sale of securities guaranteed by the SBA, the taxpayer cost of the program is only that fraction of the amount of leverage which is needed to fund anticipated future losses:

Fiscal Year	Leverage Provided	Taxpayer Appropriation
1994	$278 million	$38.4 million
1995	$371 million	$46.4 million
1996*	$452 million	$57.2 million

*Administration budget

The fiscal year 1996 budget request of $57.2 million will allow the SBA to provide $452 million of leverage to SBICs and SSBICs. Since leverage is provided proportional to private capital, we anticipate this leverage will be matched by at least $225 million of private funds, thus making over $675 million available for investment in small businesses. Since SBIC financing is typically equity or subordinate debt, this level of investment should allow these small companies to borrow at least another $450 million from conventional sources, bringing the total amount added

to $1.1 billion.

Thus, the $57.2 million of the budget proposed will support the availability of over $1.1 billion to small businesses to support their growth and development. This is truly an investment program that creates jobs and economic development. This in turn will produce tax revenue well beyond the amount appropriated for the program.

AVOIDING THE ABUSES OF THE PAST

The new regulations issued in April 1994, coupled with changes in administrative practices, have addressed the problems in the SBIC program. The new regulations were recommended by an Industry Advisory Council appointed by former Administrator Saiki in 1991, and enabled by the bipartisan Small Business Equity Enhancement Act of 1992. The new administrative practices effected by SBA management include:

1. Careful screening of license applicants, especially for quality and experience of management. The most serious weakness of the program in the past has been the licensing of inexperienced managements. As further assurance of an independent evaluation, regulations now require that for a licensee using participating securities, at least 30 percent of the private capital of an SBIC be invested by institutional

or public investors, or other parties unrelated to the SBIC managers.

2. Introduction of the Participating Security form of financing. This is an equity instrument providing patient capital consistent with a strategy of long term equity investments, coupled with a profit participation for the SBA, which should offset losses from this security.

For those SBICs which primarily loan funds, debenture financing terms have been importantly revised, to allow prepayment without penalty after five years, allowing refinancing in periods of interest rate declines.

3. Increased size of SBICs. SBICs licensed in fiscal year 1994 had average private capital of $15 million, compared with $2.4 million for those added to the program in 1992. This added size enables an SBIC to have better management and greater diversity of investments.

4. Tightened credit review. Leverage now is granted only after a thorough review of the SBICs operations and financial condition, including a review of portfolio valuations.

5. Improved oversight of licensees through more comprehensive and more frequent field examinations coupled

with more effective monitoring and credit reviews. On average, licensees are now examined once every 14 months, whereas two years ago the average period between examinations exceeded two years. Examiners now visit portfolio companies as well as the SBICs, and they are responsible for reporting on all infractions or questionable areas they uncover.

Examination findings are considered by the Investment Division Operations office, which monitors and services the licensees. Based on this review, the Division determines the appropriate action to be taken, which can include, in extreme cases, transfer to liquidation.

LIQUIDATIONS

Through fiscal year 1994, in the 35 years since inception of the program in 1958, $3.4 billion of leverage was provided by the SBA to SBICs and SSBICs. Losses through September 30, 1994 totalled $231 million, or 6.8 percent of total disbursements.

The SBA vigorously pursues recovery of the assets of those SBICs that fail. Reflecting the time it takes to liquidate the unmarketable holdings of SBICs, the SBA has 192 former licensees in liquidation, with outstanding leverage of $521 million, of which the SBA expects to recover $268 million, and to write off $253 million. Of these, 78 percent had private capital of less than the

current statutory minimum of $2.5 million, and 93 percent had private capital below the current minimum of $5 million. Only four, or 2 percent, had private capital above $10 million, the current minimum for users of Participating Securities.

Approximately $18 million of the leverage in liquidation was collected in the five months ending February 28, 1995, and $2.1 million was written off. Five additional SBICs have been brought into liquidation during Fiscal 1995 to date, with $4.5 million of leverage, and 3 cases were closed. Judgments were secured on almost $8 million of interest receivable, which was added to the leverage outstanding.

THE SSBIC PROGRAM

The SSBIC program provides equity capital and long term loans exclusively to businesses owned and controlled by persons whose participation in the free enterprise system is hampered because of social or economic disadvantages. The SSBICs operate under regulations similar to the regular SBICs. They can apply for all the forms of leverage available to regular SBICs, plus subsidized debentures and 4 percent preferred stock.

Most of the smaller SSBICs are active in ethnic communities, in which they are recognized as significant sources of support to local businesses, such as food stores, laundromats, and dry

cleaners. Virtually all of these financings are loans, since there is typically no opportunity for generating an investment return from investor ownership of equity in these concerns.

The larger SSBICs are more likely to provide debt with equity conversion or option features, in larger small businesses. Less often, they acquire a direct equity interest in these companies. Both of these investment patterns are important to the financing of disadvantaged businesses. The very small, local concerns receiving loans from the smaller SSBICs are often anchors of their communities, providing jobs and a sense of progress along with the products or services they provide. Investments in larger businesses are extremely significant, since studies have repeatedly shown that businesses owned and controlled by persons whose participation in the free enterprise system is hampered by social or economic disadvantages are a major source of economic development and job creation for these communities.

There are 94 SSBICs with $187 million of private capital and $281,000,000 of leverage supplied or guaranteed by the SBA. To examine the program and suggest improvements to better serve its market, the SBA has appointed an SSBIC Advisory Council of leaders in the investment field, including small business owners, SSBIC managers, and experts from the private sector.

The Council is Chaired by Leslie Brun, a widely respected

"gatekeeper" who matches institutional investors with venture capital firms. It is supported by a consulting agreement with Prof. Timothy Bates, author of the landmark "Banking on Black Enterprise."

ADMINISTRATION

The SBIC and SSBIC programs are administered by the Investment Division of the SBA, which has 61 employees in Washington, and 30 examiners located around the country. The cost of administration is approximately $6 million annually. The SBIC program generates more than $3 million of annual fee income.

During the past year, a principal focus of the Division has been on implementing the new regulations and assuring that new licenses are granted only to strong, experienced, and able managers. Limited personnel resources have now been shifted more heavily to the servicing and regulation of licensees, even though this has severely limited capacity for processing new applications.

The Division continues to explore ways of improving service at reduced cost, including a study of ways to privatize the portions of the program which are still provided by SBA. The challenge is to develop a private program that can continue to provide equity

capital and long term debt to small businesses, yet with a significant reduction or elimination of a Federal budget authorization.

CONCLUSION

Madam Chairman, the SBIC program is needed more today than ever. It fills a gap in available financing sources to smaller businesses, since most private venture capital firms are now so large that they are unwilling to make individual investments of less than several million dollars. For over 35 years the SBIC program has made equity capital and long term debt available to small businesses throughout the United States. Many companies which are household names received early financing from this source.

In April 1994, the bipartisan efforts of Congress and two Administrations produced a major improvement to the program, which has attracted to it experienced venture investors with private capital resources which are much higher than the SBICs of the past. Without question, the SBICs of the future will be even more effective in creating jobs and generating economic activity, while producing a much higher net profit for the Federal treasury.

Thank you very much for the opportunity to testify today. I will be happy to answer any questions you may have.

SBIC PROGRAM

New Licensees FY 1994 and 1995

SBICs Using Participating Security Leverage

AVI Capital L.P., Los Altos, CA. Private capital initially $2.8 million; to increase to $22 million. Participating Securities. Investment focus in seed and start-up information technology companies. Management: Peter Wolken, Barry Weinman, and Brian Grossi. Each of these individuals have at least 12 years of venture investing experience.

Anthem Capital, L.P., Baltimore, MD. Private capital initially $13 million; to increase to $20-30 million. Participating Securities. Investment focus in companies with $2-10 million of revenue, plus some earlier stage. Management: William Gust, venture capital investor 16 years (CEO of Chespeake Ventures, L.P., CEO OF Broventure Corp); J.C. Weiss, venture capital investor 10 years (Maryland Venture Capital Trust, Utech Funds); Ed Spiva, 20 years with NationsBank, currently EVP of Baltimore Development Corp.

Aspen Ventures West II, L.P., Los Altos, CA. Private Capital initially $2.5 million; to increase to $12 million. Participating Securities. Investment focus in early stage investments in software-based information science companies located predominately in California. Management: E. David Crockett, venture capital investor 10 years (3i Ventures, CEO of Dataquest); Thaddeus J. Whalen, venture capital related experience 9 years.

Canaan SBIC, L.P., Rowayton, CT. Private Capital initially $3.5 million; to increase to $15 million. Participating Securities. Investment focus in growth/expansion financing. Management: Jim Fitzpatrick, venture capital investor 13 years (GE Venture Capital Corp., & Canaan Org.); Eric Young, venture capital investor 12 years (GE Venture Capital Corp., & Canaan Org.); Gregory Kopchinsky, venture capital investor 4 years.

DFW Capital Partners, L.P., New York, NY. Private Capital initially $3.5 million; to increase to $20 million. Participating Securities. Investment focus in high technology and health sciences expansion financing. Management: Donald F. DeMuth, venture capital investor 13 years (Demuth, Folger & Terhune); Thomas W. Folger, venture capital investor 13 years; and David C. Wetherill, venture capital investor 6 years.

EOS Partners SBIC, L.P., New York, NY. Private Capital initially $2.65 million; to increase to $14.6 million. Participating Securities. Investment focus in later stage financing. Management: Steven Friedman and Brian Young both have been venture capital investors for 11 years and both worked at Odyssey Partners, L.P.

Exeter Equity Partners, L.P., New York, NY. Private Capital initially of $3.7 million to increase to $14.9 million. Participating Securities. Investment focus on expansion or later stage financings. Management: Keith Fox, venture capital investor for 13 years.

Furman Selz SBIC, L.P., New York, NY. Private Capital initially $6 million; to increase to $22.5 million. Participating Securities. Investment focus in later stage, growth and management buyout financings. Management: Brian Friedman, venture capital related experience with Furman Selz Investors, L.P., for ten years. Has a blue ribbon advisory group.

Gateway Partners, L.P., St. Louis, MO. Private capital initially of $2.5 million, increasing to $7.5 million based upon initial capital commitments. Participating Securities. Investment focus in later stage and special situations (buyouts and recapitalizations). Management: John McCarthy, 10 years of venture capital experience and 15 years of other business experience.

KCEP I, L.P., Prairie Village, Kansas. Private capital initially $3 million; to increase to $11 million. Participating Securities. Investment focus in start-ups and early stage financings. Management: Paul Henson, venture capital related experience for 50 years (started Sprint); Bill Reisler venture capital related experience of 14 years.

Mercury Capital, L.P., New York, NY. Private Capital initially $2.5 million; to increase to 18.75 million. Participating Securities. Investment focus in early and later stage financings in basic manufacturing and distribution. Management: David W. Elenowitz, venture capital investor for 10 years.

MidMark Capital, L.P., Chatham, NJ. Private capital initially $2.7 million; to increase to $30 million. Participating Securities. Investment focus in later stage equity financings. Management: Denis Newman, venture capital investor 40 years (First Boston); Wayne Clevenger, venture capital investor 15 years (Lexington INV. Co).

Needham Capital SBIC, L.P., New York, NY. Private capital initially $2.5 million; to increase to $7.5 million. Participating Securities. Investment focus in post-development stage and management buyout financings in technology and life sciences. Management: George Needham, venture capital related investor 23 years; John Michaelson, venture capital related investor 8 years.

Odyssey Partners SBIC, L.P., New York, NY. Private capital initially $9 million; to increase to $45 million. Participating Securities. Investment focus in middle to late stage venture capital opportunities and middle market buyouts. Management: Stephen Berger, venture capital related investor 8 years; Alain Oberrotman, venture capital investor 4 years.

Pacific Northwest Partners SBIC, L.P., Bellevue, WA. Private capital initially $5.3 million; to increase to $10.6 million. Participating Securities. Investment focus in early stage equity financings in software, healthcare and specialty retailing companies. Management: Theodore Wight, venture capital investor 14 years (Walden Capital Partners).

Piper Jaffray Healthcare Capital, L.P., Minneapolis, MN. Private capital initially $3 million; to increase to $7.5 million. Participating Securities. Investment focus in early and later stage financings in medical devices and healthcare services. Management: Lloyd Benson, venture capital investor 11 years (Piper Jaffray Funds).

Pioneer Ventures L.P., Boston, MA. Private capital initially of $2.6 million, increasing to $15 million. Participating Securities. Investment focus: 50% early stage and 50% later stage. Management: Frank Polestra, venture capital investor 13 years; Christopher Lynch, venture capital investor 16 years; Walter Dick, venture capital investor 9 years; and Leigh Michl, venture capital investor 5 years.

RFE Investment Partners V, L.P., New Canaan, CT. Private capital initially $7.1 million; to increase to $35.7 million. Participating Securities. Investment focus in later stage low tech financings. Management: James Parsons, venture capital investor 13 years.

River Cities Capital Fund, L.P., Cincinnati, Ohio. Private capital initially $2.7 million; to increase to $11.6 million. Participating Securities. Investment focus: 35% to 55% in start-up and early stage financings in manufacturers, distributors, broadcasting and service companies. Management: R. Glen Mayfield, venture capital related investor 26 years; Edwin T. Robinson, venture capital investor 5 years.

SBIC Partners, L.P., Fort Worth, TX. Private capital initially $10.5 million; to increase to $30 million. Participating Securities. Investment focus in middle to late stage financings. Management: Gregory Forest, venture capital investor 21 years (First SBIC of CA); Jeffrey Brown, venture capital investor 7 years (First SBIC of CA).

Sorrento Growth Partners I, L.P., San Diego, CA. Private capital initially $2.6 million; to increase to $10.8 million. Participating Securities. Investment focus in mid to late stage financings. Management: Robert Jaffe, venture capital investor 9 years.

Walden-SBIC, L.P., San Francisco, CA. Private capital initially \$2.5 million; to increase to \$20 million. Participating Securities. Investment focus in early stage financings in computer peripherals, software, electronics and healthcare. Management: Arthur S. Berliner, venture capital investor 20 years (Walden Funds); George S. Sarlo, venture capital investor 20 years (Walden Funds).

Zero Stage Capital V, L.P., Cambridge, MA. Private capital initially \$3.1 million; to increase to \$25 million. Participating Securities. Investment focus in early stage ventures and later stage investments. Management: Gordon Baty, venture capital investor 9 years; Paul Kelley, venture capital investor 13 years.

Licensees Using Debenture Leverage

Anker Capital Corp., Charleston, WV. Private capital \$2.5 million. Debentures. Investment focus in expansion financings primarily in West Virginia and surrounding states. Management: Thomas Loehr, venture capital related investor 5 years.

Byrd Business Investment, L.P., Nashville, TN. Private capital \$4.4 million. Debentures. Investment focus in later stage financings. Management: Damon W. Byrd, venture capital investor in his own fund.

Cordova Capital Partners, L.P., Atlanta, GA. Private capital initially \$8.1 million; to increase to \$27.5 million. Debentures. Investment focus in growth/expansion financing. Management: Ralph Wright, venture capital investor 4 years, 17 years related business experience; Lewis Manderson, Jr., venture capital investor 4 years, 31 years related business experience; Gerald Schmidt, venture investor 4 years, 24 years related business experience.

Exeter Venture Lenders, L.P., New York, NY. Private capital initially \$13.6 million; to increase to \$15 million. Debentures. Investment focus in mid to late stage financings. Management: Keith Fox, venture capital investor 13 years.

First Legacy Fund, Inc., Washington, D.C. Private capital \$3 million. Debentures. Investment focus in family owned businesses. Management: Jonathan Ledecky, venture capital investor 11 years.

Hanifen Imhoff Mezzanine Fund, L.P., Denver, CO. Private capital initially \$2.7 million; to increase to \$14.7 million. Debentures. Investment focus in mezzanine financings. Management: Edward Brown, venture capital investor 20 years; Steven Leatherman, venture capital investor 3 years.

KOCO Capital Company, L.P., Mt. Kisco, NY. Private capital \$5 million. Debentures. Investment focus in later stage financings. Management: James A. Kohlberg, venture capital investor 9 years.

Maine Capital Partners, L.P., Portland, ME. Private capital initially $2.7 million. Recently submitted application for conversion to participating securities, in contemplation of an increase in private capital to $15 million. Debentures. Investment focus in later stage and mezzanine financings. Management: David Coit, venture capital investor 18 years (North Atlantic Capital Corp.); Clayton Kyle, venture capital investor 4 years.

Novus Ventures, L.P., Cupertino, CA. Private capital $5 million. Debentures. Investment focus in the field of information technology, primarily equity investments in early stage companies. Management: Dan Tompkins, high tech venture capital investor and manager with 12 years experience (including two SBICs, one of which was Wells Fargo); Shirley Cerrudo, venture capital investor 20 years (including Wells Fargo).

Pacific Mezzanine Fund, L.P., San Francisco, CA. Private capital initially $5.1 million; to increase to $20 million. Debentures. Investment focus in expansion and acquisition financing. Management: Nathan Bell, venture capital investor 8 years (Prudential Capital Corp.); David Woodward, venture capital investor 6 years (BBU Mezzanine Fund).

Seacoast Capital Partners, L.P., Danvers, MA. Private capital initially $7.5 million; to increase to $30 million. Debentures. Investment focus in mezzanine financings in manufacturing, distribution, consumer products, healthcare and environmental services. Management: Eben S. Moulton, venture capital investor 10 years (Signal Capital Corporation); Walter H. Leonard, venture capital investor 4 years (Signal Capital Corporation).

Shaw Venture Partners III, L.P., Portland, OR. Private capital initially $2.5 million; to increase to $30 million. Debentures. Investment focus in start-up and early stage financings in several high and low tech industries. Management: Ralph R. Shaw, venture capital investor 11 years; Alan S. Dislip, venture capital investor 7 years.

Stratford Capital Group,Inc., Dallas, TX. Private capital initially $2.5 million, pending approval of change of control application, committed private capital will increase to $45 million. Debentures. Investment focus in later stage financings. Management: Michael Brown, venture capital investor with an SBIC.

Wasatch Venture Corp., Salt Lake City, UT. Private capital $4.5 million. Debentures. Investment focus in development and expansion financings. Management: Timothy Draper, venture capital investor 9 years (Draper Associates).

WestVen Limited Partnership, Charleston, WV. Private capital $2.5 million. Debentures. Investment focus in expansion financings primarily in West Virginia. Management: Thomas Loehr, venture capital related investor 5 years.

Bank-owned Licensees Not Seeking Leverage

BancFirst Investment Corp., Oklahoma City, OK. Private capital $2.5 million. Non-leveraged. Investment focus in late stage financings. Management: T. Kent Faison, several years of lending experience.

First Commerce Capital, Inc., New Orleans, LA. Private capital initially $5 million; to increase to $24 million. Non-leveraged. Investment focus in late stage financings. Management: William J. Harper, venture capital investor 6 years (Westinghouse Financial Services, Inc.).

First Security Business Investment Corporation, Salt Lake City, UT. Private capital initially $2.5 million; to increase to $5 million. Non-leveraged. Investment focus in late stage financings in manufacturing, wholesale, distribution and service. Management: Louis O. Adler, venture capital related experience with First Security Bank 13 years.

Fleet Equity Partners VI, L.P., Providence, RI. Private Capital initially of $3.2 million; to increase to $10.0 million. Non-leveraged. Investment focus in emerging and established small concerns, typically in communications and information technology concerns. Management: Robert M. VanDegna, venture capital investor for Fleet for over 18 years; and Habib Y. Gorgi, a professional venture capitalist for over 12 years.

Norwest Equity Partners V, Minneapolis, MN. Private Capital of $100 million. Non-leveraged. Investment focus in mid to late stage financings including management-led acquisitions or recapitalizations. Management: Daniel J. Haggerty has over 22 years of venture capital experience with Norwest; and George J. Still, Jr. and John E. Lindahl each has 10 years of venture capital investing experience.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

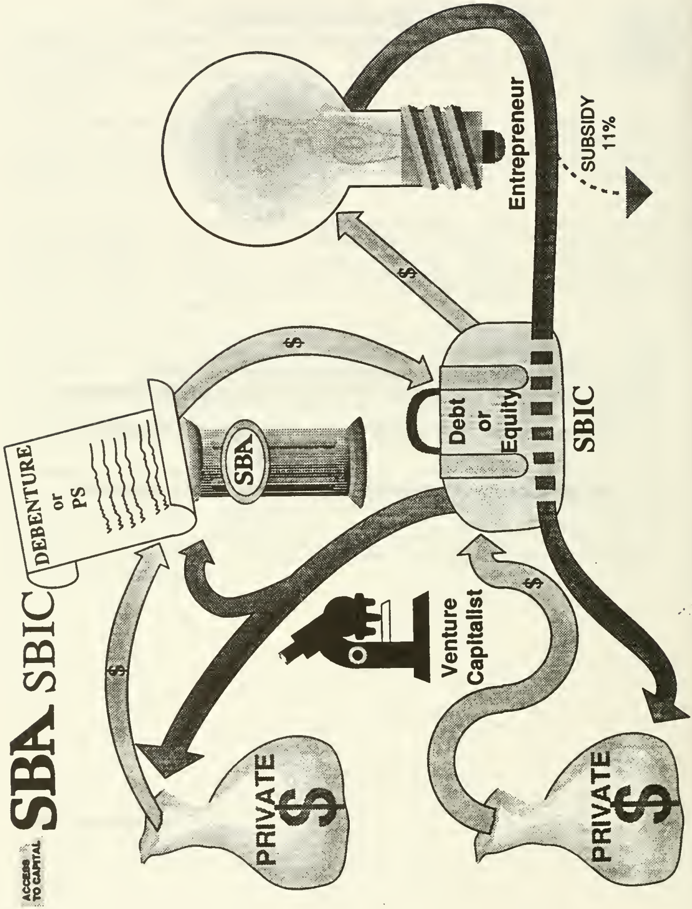
CHARTS

TO ACCOMPANY TESTIMONY OF MARY JEAN RYAN
ASSOCIATE DEPUTY ADMINISTRATOR FOR ECONOMIC DEVELOPMENT

HEARING BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS
ON

THE SMALL BUSINESS INVESTMENT COMPANY (SBIC) PROGRAM

MARCH 28, 1995


ACCESS TO CAPITAL
SBA SBIC
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SBIC
Entrepreneur
SUBSIDY 11%
Venture Capitalist
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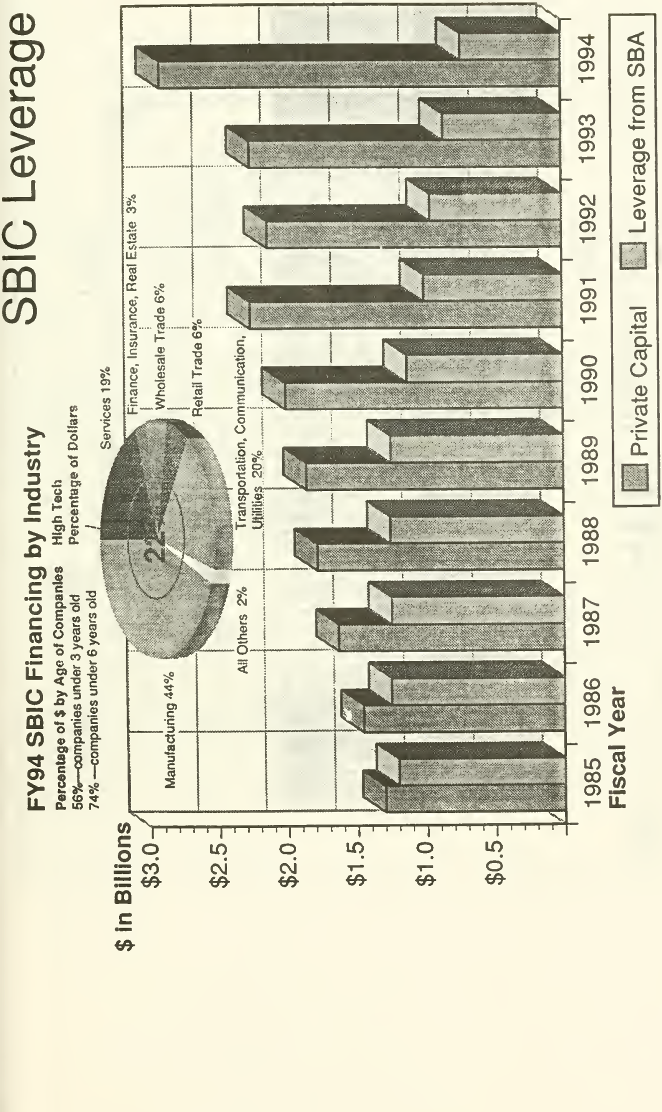
SBIC Leverage
FY94 SBIC Financing by Industry
Percentage of $ by Age of Companies
56%—companies under 3 years old
74%—companies under 6 years old
High Tech
Percentage of Dollars
Manufacturing 44%
All Others 2%
Transportation, Communication, Utilities 20%
Services 19%
Retail Trade 6%
Wholesale Trade 6%
Finance, Insurance, Real Estate 3%
$ in Billions
$3.0
$2.5
$2.0
$1.5
$1.0
$0.5
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
Fiscal Year
Private Capital
Leverage from SBA

ACCESS TO CAPITAL

SBA Today's SBIC

	Before (1992)	After (1994)
Financing of Small Companies	$449 million	**$948 million**
New Private Capital Licensed	$24 million	**$520 million**
Private Capital per New Licensee*	$2.4 million	**$15 million**
Cost to Taxpayer	$12 million	**$34 million**
SBA Leverage	debt instrument only	**flexible debt or equity instrument**

*excluding bank subsidiaries

TESTIMONY OF

WILLIAM R. THOMAS

PRESIDENT OF CAPITAL SOUTHWEST CORPORATION

BEFORE THE

COMMITTEE ON SMALL BUSINESS

UNITED STATES HOUSE OF REPRESENTATIVES

March 28, 1995

Chairman Meyers, Distinguished Committee Members and Staff:

I am William R. Thomas, president and chairman of Capital Southwest Corporation, a publicly-owned venture capital investment company located in Dallas, Texas. Next month I begin the 34th year of my venture capital career - all with Capital Southwest. Previously, I held management positions in the chemical industry and with a consulting firm and was an Army officer for 5 years including a year of combat service in Korea. My education includes a BS from Texas A&M and an MBA from Harvard Business School. In 1984-85 I served as chairman of the National Association of Small Business Investment Companies and in 1991-92 I served on the SBA's Investment Advisory Council, which developed recommendations for a redesign of the small business investment company (SBIC) program. Also, I have served as a governor of the NASD and chairman of its Corporate Advisory Board.

Capital Southwest Corporation, of which I have been president since 1980, is our country's largest publicly-owned venture capital investment company, with net assets of $135 million. When it was formed in 1961, our company was one of the more than 40 publicly-owned SBIC's. Today, we have an SBIC subsidiary which holds approximately one-third of our assets and has issued $11 million of SBA guaranteed debentures. The remainder of our assets are held by the parent company, which is a business development company not regulated by the SBA. On a consolidated basis, Capital Southwest and its SBIC subsidiary hold investments in 33 portfolio companies and have achieved above-average investment results. During the past 15 fiscal years ended March 31, 1994, our net assets have grown from $18 million to $133 million and net asset value per share has grown at a compound annual rate of 19% assuming reinvestment of all dividends and tax credits on retained capital gains. During this entire 15 year period, an average of only 10.8% of our capital was derived from SBA guaranteed debentures, which we had the resources to retire at all times.

Observations on the SBIC Program

The SBIC program has been a government program that has worked. In fact, it has worked so well that it will be feasible to eliminate Federal funding and guarantees in the near future. The following observations are offered in support of this position:

- SBIC's, with less than $3.0 billion in private capital and SBA leverage, represented less than 10% of the $34.8 billion in venture capital under management at the end of 1993, as reported by Venture Economics, Inc. This aggregate venture capital pool is nearly three times the $12.1 billion reported in 1983 and nearly 12 times the estimated $3.0 billion in 1973. Thus, the contracting SBIC program has been an effective pioneer for a robust venture capital industry, which has attracted major amounts of capital without government subsidies or intervention.

- SBIC subsidiaries of commercial banks, which represent a majority of the private capital in the program, do not in most cases rely on Federal funding, but use their SBIC's to avoid Glass-Steagall ownership limitations.

- The vast majority of SBIC's have investment objectives which are identical to the objectives of non-SBIC venture capital firms. For example, in 86% of the investments made by our company during the past six years, non-SBIC venture firms have either competed with us, co-invested with us, or both. The other 14% of these investments would have been attractive to many non-SBIC venture capital firms.

- The redesigned SBIC program will produce unintended consequences. The new participating preferred, which on a risk-reward basis appears to be tilted in favor of SBIC owners at the expense of taxpayers, is attracting a horde of opportunists, many of whom could instead raise capital from the private sector. Interest in forming SBIC's has also been stimulated by the recent major increase in size standards, thereby permitting investments in some businesses which seem too big to be classified as small. The product of these two factors will inevitably increase the crowd at the government trough and cause taxpayers to subsidize venture capital activities which the private sector is already funding without government involvement.

- An SBIC program which provides Federally-guaranteed funding (through either debentures or participating preferred) interferes with capital markets and deprives non-participants of a level playing field. To obtain capital at the lower cost promised by the new participating preferred, non-SBIC venture capital funds will be drawn increasingly to the SBIC program as opposed to private sector sources.

- Try as it may, the SBA will never be able to allocate capital as effectively as entities that are governed by the marketplace and are politically independent. This has been proven again and again since the inception of the SBIC program as the SBA has at times imprudently issued licenses to unqualified, unethical operators and thereby lost the taxpayers' money.

- Specialized Small Business Investment companies ("SSBIC's"), which have enabled a limited number of socially and economically disadvantaged entrepreneurs to participate in the free enterprise system, should provide financing only to disadvantaged minorities. Unfortunately, the scope of the SSBIC program has been broadened beyond minorities to include enterprises managed by women and Viet Nam veterans. In view of the desirability of developing minority businesses, tax incentives rather than Federal funding would be a better way to encourage large corporations and financial institutions to increase their investments in SSBIC's.

Rationalizations in Support of the SBIC Program

Advocates of continued Federal funding or guarantees for the SBIC program rely on a standard set of rationalizations. At one time, some of these claims had substantial validity. Today, they have far less merit. Several of the usual special interest arguments and my responses are as follows:

There is an acute shortage of venture capital.
There is not a shortage as evidenced by the pool of $34.8 billion of venture capital in 1993 and the obvious degree of competition among venture capital firms. Although the February 1992 report of the Investment Advisory Council to the SBA administrator stated "institutional funding to the private venture capital industry is in sharp and continuing contraction," new capital commitments (according to Venture Economics) promptly rebounded from a low of $1.271 billion in 1991 to $2.548 billion in 1992, $2.545 billion in 1993 and an estimated $3.800 billion in 1994. Investment activity also soared during 1992, 1993 and 1994. In recent years, too much venture capital has been chasing too few good opportunities.

SBIC's serve different markets than non-SBIC venture capital firms.
As discussed earlier, the vast majority of SBIC's have investment objectives identical to non-SBIC venture firms. Non-venture SBIC's engaged in spread lending hold less than 20% of the industry's assets and generally finance small enterprises with little or no growth potential. Also, geographic diversity of SBIC's is of little importance, since venture capital firms will travel anywhere, anytime for rewarding investment opportunities.

SBIC's have been primary financing sources for outstanding growth firms.
Some of the SBIC promotional material implies that the SBIC industry was primarily responsible for developing an array of outstanding growth firms including Apple, Intel and Federal Express. A more accurate description would also credit the many non-SBIC venture investors in such firms with a large measure of these investment successes.

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Recommendations

The SBIC program, while far from perfect, has been the cornerstone on which today's venture capital industry has been built. However, the SBIC program has now served its purpose and this is an appropriate time to declare victory and either phase it out or privatize it. To achieve this objective, the following steps are recommended:

- Suspend all further Federal guarantees or financings of SBIC's (and SSBIC's) except future maturities of existing debentures, which would be extended to mature in 2002. This would provide an adequate time period to either liquidate established portfolios or refinance existing indebtedness.

- Devise tax incentives to encourage the formation of SSBIC's by large corporations and financial institutions.

- Continue licensing privately-funded SBIC's, either through the SBA or another Federal agency. This would accommodate banking institutions which require Glass-Steagall exemptions and other entities which are attracted to the SBIC program by the ordinary loss treatment of SBIC stock investments, and by the use of SBIC's to make investments qualifying for the targeted capital gains tax rate.

- Alternatively, it may be feasible to privatize the entire SBIC industry on a basis which involves no Federal guarantees or backstops, but enables the industry to sell securities on a pooled basis, to meet its financial requirements. Any such privatization structure should remove the entire program from the supervision of the SBA or any other Federal agency and as a quid pro quo, relieve the government of any guarantee obligations on future financings.

Because this hearing is devoted to the Small Business Administration's SBIC program, I have not commented on the broad array of other SBA activities, which must be viewed as primary candidates for elimination along with the SBA itself. Foremost among these programs is the Guaranty Loan Program, which is systematically enriching the nation's banks and other lenders at the expense of the taxpayers. Another program which should be terminated without reservation is the SBA's Contracting and Business Development Program ("the 8(a) Program"), which on a preferential basis grants government contracts to firms managed by socially and economically disadvantaged individuals. This program has reportedly been a magnet for abuse and fraud.

Attachment 1 hereto is a copy of my letter of January 16, 1995 to The Honorable Jan Meyers which was written to set forth a number of observations on the SBA, which I view as an unnecessary government activity serving only a minute fraction of the nation's small businesses. *As your committee conducts a critical review of the many facets of the SBA, I believe you will find that small business is vital to our economy, but the Small Business Administration is not.*

Thank you for the opportunity to testify. I will welcome your questions.

Attachment 1

Capital Southwest Corporation

12900 Preston Road at LBJ
Suite 700
Dallas, Texas 75230
214•233-8242 Fax 214•233-7362

William R. Thomas
President and Chairman

January 16, 1995

The Honorable Jan Meyers
U.S. House of Representatives
Washington, DC 20515

Dear Ms. Myers:

The Small Business Administration ("SBA") is an unnecessary government activity which serves only a minute fraction of the nation's small businesses. Today, our free enterprise system efficiently meets the financial and management needs of the small business community. Tomorrow, if there were no SBA, little would change.

Paradoxically, I am writing as a disenchanted member of a special interest group who believes that the viability of our nation and the future welfare of our children and grandchildren can no longer be subordinated to the selfish interests that have dominated our national agenda for over 40 years. As president of our country's largest publicly-owned venture capital investment company, which has over one-third of its assets in a Small Business Investment Company ("SBIC") licensed by the SBA, I have been intimately involved with the financing and development of small businesses and with a number of the SBA's programs for more than 30 years. It is from this perspective that I offer the following observations:

- Small Business Investment Companies have served a valuable purpose, but no longer require Federal funding. During the quarter century after its inception in 1958, the SBIC program gave birth to the privately funded institutional venture capital industry, which is totally independent of SBA. Today, SBIC's represent less than 10% of the more than $30 billion in resources of the venture capital industry and in most cases have investment objectives identical to non-SBIC venture firms. A majority of the private capital in the SBIC program is invested by commercial banks, which use their SBIC's to avoid Glass-Steagall stock ownership limitations and generally elect not to rely on Federal funding. A small proportion of SBIC's are primarily lenders (rather than equity investors) serving small businesses which typically have low growth potential.

- The SBA lacks the seasoned judgment and political independence to avoid continuing its costly mistakes in licensing and lending to Small Business Investment Companies. The surge of applications for licenses to operate SBIC's to be funded under the recently redesigned program will inevitably result in SBA licensing and lending to many unqualified managements who will lose the government's money as well as their own.

- The redesigned Small Business Investment Company program is drawing applicants who have access to private capital, but are attracted by the favorable terms of Federally-funded participating preferred securities and subordinated debentures. Why should the Federal government provide financing to SBIC's, particularly those organized by Henry Kravis, by the Bass interests or by Hicks, Muse, Tate & Furst? Or by major investment and commercial banks? Or by Capital Southwest Corporation?

- Specialized Small Business Investment companies ("SSBIC's), which have enabled a limited number of socially and economically disadvantaged entrepreneurs to participate in the free enterprise system, should provide financing only to disadvantaged minorities and should soon operate without additional Federal funding. Unfortunately, the scope of the SSBIC program has been broadened beyond minorities to include enterprises managed by women and Viet Nam veterans. As graduate business schools and American industries turn out more and more qualified minority managers, the need for specialized financing sources will diminish. In view of the desirability of developing minority businesses, it is probable that large corporations and financial institutions will increase their investments in SSBIC's as Federal funding is phased out.

- The Guaranty Loan Program is essentially a welfare program for the nation's commercial banks, whose loans to small business concerns are 85% guaranteed by SBA. If this major government safety net were withdrawn, lenders would make more prudent credit judgments. Creditworthy small businesses would still receive loans, but many marginal enterprises would not. This costly program is a classic example of government waste.

- The Certified Development Company (503/504) Program enabling small businesses to acquire land, buildings and equipment is an unnecessary Federal intervention in a market which is adequately served by the private sector. This program saddles the SBA as a second mortgage lender with much of the risk that would otherwise be borne by commercial banks and other first mortgage lenders.

- The Direct Loan and Special Loan Programs of the SBA are bureaucratic mazes, which have a negligible effect upon those small businesses that are vital to our nation's economy. These loan programs are inconsequential to creative entrepreneurs, whose financial requirements are readily met by the private sector.

- The SBA's Contracting and Business Development Program ("the 8(a) Program"), which grants certain government contracts to firms managed by socially and economically disadvantaged individuals, has been a wasteful, inefficient attempt to interfere with the marketplace. This program has had a history of abuse and fraud, which our government cannot afford. It is an unnecessary crutch for efficient small businesses.

- The SBA has a multitude of ineffective management assistance programs and publications which are largely ignored by the small business community. In dealing with several thousand small business concerns over the past three decades, I have found only a handful who have been assisted by the SBA or its national network of universities and other entities designated as Small Business Development Centers or Small Business Institutes. Instead, discerning entrepreneurs rely on the private sector to obtain more experienced, reliable professional services and counsel and on the vast array of readily available business literature.

- Recommendation: Dismantle the Small Business Administration and terminate all if its activities except disaster relief, Federal loans or guarantees to SBIC's or SSBIC's during a period ending within five years and continued licensing of privately funded SBIC's and SSBIC's. Retain only the staff required for such continuing activities and for protecting and liquidating the government's interest in the SBA's portfolio of direct and guaranteed loans.

This letter is a contradiction of my past positions as a long-standing member of a special interest group. In the past I have served as chairman of a trade association intent on expanding SBIC programs. I have written letters, called on congressmen and senators, served on the SBA's Investment Advisory Council and given speeches and testimony - all to further the interests of the SBIC industry and enlarge the scope and availability of the government trough.

Finally, I have joined the growing ranks of those who acknowledge that the survival of our country depends on our citizens placing national interest above self interest. It is past time for all of us to back away from the trough as it is withdrawn.

I urge you to conduct a critical review of the many facets of the Small Business Administration in concert with other elected officials to whom I am also writing. I believe you will find that small business is vital to our economy but the Small Business Administration is not.

Sincerely,

William R. Thomas

United States General Accounting Office

GAO

Testimony

Before the Committee on Small Business, House of Representatives

For Release on Delivery
Expected at
10 a.m. EST
Tuesday
March 28, 1995

SMALL BUSINESS ADMINISTRATION

Status of Small Business Investment Companies

Statement of Jim Wells, Associate Director, Housing and Community Development Issues, Resources, Community, and Economic Development Division

GAO/T-RCED-95-145

Madam Chair and Members of the Committee:

We are pleased to be here today to discuss the Small Business Administration's (SBA) Small Business Investment Company (SBIC) and Specialized Small Business Investment Company (SSBIC) programs. Licensed and regulated by SBA, these investment companies are privately owned and managed firms that provide funding to small businesses through equity investments (stock purchases) and loans for starting, modernizing, or expanding operations. SBICs and SSBICs use their own funds and funds obtained by borrowing at favorable rates with an SBA guarantee and/or by selling preferred stock to SBA. SSBICs, which are generally smaller firms, must fund only businesses owned by socially or economically disadvantaged persons. At the end of fiscal year 1994, 186 SBICs and 94 SSBICs provided $947.8 million in financial support to small businesses under the two programs.

Over the years, we have reported on problems with SBA's oversight of the SSBIC program, such as inadequate documentation of eligibility and prohibitive financial transactions of the program's requirements. You asked us earlier this year to begin a comprehensive assessment of the SBIC and SSBIC programs. At your request, our testimony today, which is based on our ongoing work and our preliminary findings, will focus on SBA's oversight and examinations, licensing, and liquidation. We will also address the implementation of the Three Percent Preferred Stock Repurchase Program.

In summary, we have found the following:

-- SBA identified 111 SBICs and SSBICs that are active or currently in liquidation that have engaged in regulatory violations and misconduct, such as giving loans improperly to business associates and making prohibited investments in real estate. At least 20 licensees or their small business investments are currently under investigation either by the

SBA Inspector General or the Justice Department for criminal misconduct.

-- SBA successfully increased the frequency of examinations of SBICs and SSBICs--from every 22 months to every 14 months on average. In 1994, 220 examination reports cited 552 violations, and problems that were unresolved from one examination period to the next. Furthermore, the current placement of the examination function--in the office that also manages the programs--may impede its independence.

-- Under recently revised procedures intended to strengthen its program, SBA licensed 37 new SBICs but no new SSBICs. The new SBICs are heavily capitalized--with an average of about $16.1 million in private funds compared to earlier averages of $4.8 million.

-- The 192 SBICs and SSBICs currently in liquidation owe SBA $790 million, of which the agency projects to recover $443 million, or 56 cents on the dollar.

-- Finally, under the stock repurchase program, 15 SSBICs have repurchased $41 million (par value) in preferred stock from SBA for $14 million. The Congress authorized SBA to allow repurchase at a price less than its par value.

SBA has responded to many criticisms of the SBIC and SSBIC programs in recent months by changing its rules, regulations and procedures to focus on licensing larger, better capitalized, and more experienced applicants. SBA officials believe that these recent front-end changes will go a long way to ultimately strengthen the program and reduce its loss rates in the future. Because these changes are relatively new, it is too early to measure their impact.

BACKGROUND

The SBIC and SSBIC programs, administered by SBA's Investment Division, are the federal government's vehicles for making financing and management assistance available to small businesses that historically may not have been able to obtain financing from either conventional lending institutions or private venture capital firms. SBA points out that a number of major U.S. companies trace their initial financing to SBICs, including Apple Computer, Federal Express, and Intel Corporation. In providing this financing, SBICs and SSBICs use their own private funds and moneys guaranteed by SBA. The law requires SBICs and SSBICs to have a minimum of $2.5 million and $1.5 million in private capital, respectively. SBA can provide leverage of up to $3 for every $1 of the private capital for an SBIC and $4 for an SSBIC.

The Offices of Operations, Examinations, Licensing, and Liquidation are all in SBA's Investment Division. Analysts in the Operations office monitor, regulate, and provide operational assistance to SBICs and SSBICs. The Examinations office was created in 1992, when the Congress transferred responsibility for periodic examinations of SBICs and SSBICs from the Office of Inspector General (OIG) to the Investment Division.

The Office of Licensing, in April 1994, began using revised procedures for licensing SBIC and SSBICs. The changes were intended to strengthen the licensing process and provide a greater assurance that licensees would be successful. The Liquidation office oversees the disposal of assets of failed SBIC and SSBICs that are placed in liquidation by SBA for willfully or repeatedly violating the program's requirements; surrendering their license when they cannot repay funding owed to SBA; or voluntarily assigning their assets to SBA in exchange for forgiveness of the debt owed to SBA. The disposal of assets may be done through a receivership or directly by SBA.

According to SBA, over the past 35 years, the SBIC and SSBIC programs have provided approximately $12 billion in financing to over 75,000 small businesses, and have created over a million jobs in the manufacturing and service sectors of the economy.

PROHIBITED BUSINESS PRACTICES
HAVE OCCURRED AT SBICS AND SSBICS

In March 1994, our Office of Special Investigations reported on an SSBIC that engaged in prohibited transactions, including giving loans to the owner's business associates, making loans for purchasing real estate, and providing loans to business ventures owned by individuals with questionable eligibility.[1] At our request, SBA examiners identified 111 SBICs and SSBICs--half active and half currently in liquidation--that have engaged in regulatory violations and misconduct, including the following examples:

-- One SBIC was cited in three examinations since 1990 for having financial and operating interests in real estate, oil, and gas ventures--all prohibited investments. The SBIC anticipates executing a divestiture plan in March 1995.

-- Another SBIC knowingly submitted false and misleading financial information to SBA. The SBIC is in liquidation and SBA expects to lose over $700,000.

-- The president of one SBIC and his family charged over $200,000 in personal expenditures to the SBIC's travel and entertainment account. The SBIC is in liquidation, and SBA expects to lose $2.2 million.

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[1]Small Business Administration: Inadequate Oversight of Capital Management Services, Inc.--an SSBIC (GAO/OSI-94-23, Mar. 21, 1994).

-- One SSBIC financed a small business that was owned and managed by an associate. An earlier examination cited a similar conflict-of-interest financing to the same small business. The SSBIC is in liquidation.

-- Another SSBIC made a $260,000 loan to a liquor store owner, part of which was used to purchase a $250,000 home. This SSBIC is in liquidation and SBA expects to lose $1.6 million.

At least 20 SBICs, SSBICs or their small business investments are currently being investigated by the SBA Inspector General or the Department of Justice for criminal misconduct, including food stamp fraud and money laundering. In large part, these prohibited business practices occurred because of problems in the programs' oversight and licensing. Because SBA has made recent changes in these areas, we are continuing our review to assess the potential impact of these changes in preventing future problems of this nature.

SBA'S OVERSIGHT OF SBICS AND SSBICS

The Offices of Operations and Examinations are currently responsible for overseeing the SBIC and SSBIC programs. Since 1992, when the examination function was moved out of the OIG, the frequency of examinations has steadily improved--from every 22 months to every 14 months on average and the goal is to examine each SBIC and SSBIC in which SBA has a financial interest once a year. The examiners, in fiscal year 1994, reported over 500 regulatory violations.

The Organizational Placement of Examinations May Impede Independence

While we found no indication of efforts to restrict or influence examinations, the current organizational placement of the Office of Examinations within the Investment Division, with all examiners responsible to the Associate Administrator for Investment, may create a question about its independence. The Associate Administrator for Investment is also responsible for all other aspects of the SBIC and SSBIC programs, including licensing and monitoring. As head of the division that administers the SBIC and SSBIC programs, the Associate Administrator is the advocate for the programs--internally to SBA and externally, to the small business investment communities.

Since the ultimate responsibility for ensuring that examination findings are adequately resolved rests with the Associate Administrator for Investment, this arrangement may not be the most appropriate to ensure that examinations are conducted in an independent environment.

Violations Are Reported But Many Go Unresolved

In fiscal year 1994, the Office of Examinations issued 220 reports citing 167 SBICs and SSBICs for 552 violations of 36 different regulations. The greatest number of violations--79--were related to the SBICs' and SSBICs' internal controls. Other frequently cited violations involved prohibited uses of funds, conflicts of interest, and not having or following portfolio valuation procedures.

Over the 12 months ending February 28, 1995, 136 reported violations were unresolved from previous examinations. For example, two separate examination reports cited an SBIC for failing

to maintain adequate controls over portfolio valuations. As a result, the SBIC may have materially overstated the value of its portfolio and therefore, failed to notify SBA of its regulatory capital impairment. In another instance, an SSBIC had an outstanding violation for making a loan to a former board member to pay personal income tax, within 6 months of the board member's resignation. This same SSBIC in consecutive examinations was cited for providing financing to a business owner who was not a member of a designated disadvantaged group.

Relating to this issue, SBA is having trouble verifying that the SBICs and SSBICs invest in businesses that meet the program's eligibility criteria. SBA does not collect data on the gender, ethnicity, or economic status of the small businesses in the SSBICs' portfolios. In April 1994, we reported that SSBICs often do not comply with SBA's guidance for documenting the eligibility of the small businesses they finance.[2] We estimated that for more than a third of all the small businesses financed, SSBICs did not prepare eligibility profiles to document that the businesses were owned by persons who were socially or economically disadvantaged. SBA officials told us that forms have been designed to better collect this information; the revised forms are currently being reviewed by the Office of Management and Budget.

CHANGES IN SBA'S LICENSING PROCEDURES

The procedures used by SBA to license an SBIC or SSBIC before 1994 focused little attention on the background and expertise of the prospective licensee. SBA's April 1994 new licensing procedures encourage admission to the program for more highly capitalized and experienced applicants. For example, the 37 SBICs licensed under

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[2]Small Business Administration: Inadequate Documentation of Eligibility of Businesses Receiving SSBIC Financing (GAO/RCED-94-182, Apr. 26, 1994).

the new procedures averaged $16.1 million in private capital compared with an average of $4.8 million at the beginning of fiscal year 1994. While it is too early to tell for certain, these changes are intended to create a more financially stable class of SBICs and SSBICs and reduce SBA's losses.

No SSBICs Were Licensed in 1994

The 1972 amendments to the Small Business Investment Act of 1958 require that SSBICs invest only in small businesses owned by persons whose participation in the free enterprise system is hampered because of social or economic disadvantage. But neither legislation nor SBA's regulations define social or economic disadvantage--though SBA has established criteria for determining whether a small business is socially or economically disadvantaged.

The need for a definition of participants in the SSBIC program was a reason that SBA officials cited for the establishment of an advisory committee of experts to review all aspects of the program. The committee is expected to report its findings and recommendations in May 1995.

LIQUIDATION RECOVERIES
ARE PROJECTED TO DECLINE

Since December 1966, 584 SBIC and SSBICs with funding of $1.18 billion owed to SBA have been transferred to the Office of Liquidations. Of the 192 SBICs and SSBICs currently in liquidation, owing $790 million to SBA, SBA projects to recover 56 cents on the dollar. In contrast, SBA recovered 70 cents on the dollar in prior years from completed liquidations.

In May 1993, we reported that most SBICs entering liquidation were not in compliance with SBA's regulations pertaining to overall

financial performance.[3] Specifically, 81, or nearly two-thirds, of the 126 SBICs that entered liquidation between January 1986, and March 1991, did so because (1) their losses, in comparison to their private capital, exceeded an acceptable level (capital impairment); (2) they defaulted on their agreement for repaying funds owed to SBA; or (3) they were bankrupt. In other instances, liquidations occurred because SBICs voluntarily surrendered their license to withdraw from the program or committed regulatory violations such as making ineligible investments.

Most Future Losses Are Projected From SBICs and SSBICs Liquidated Through Receiverships

A receivership is a process by which the court takes control of assets. SBA places SBIC and SSBICs in receiverships when officials determine that the receivership process is the most appropriate means to recover SBA's money. The receivership process is done under court order in which a U.S. District Court generally appoints SBA as receiver to sell off the assets of the SBIC and SSBIC.

As of December 31, 1994, 71 SBIC and SSBICs with $264 million in funding from SBA were in receivership. These companies account for $146 million, or 42 percent, of the losses SBA expects to incur from all of those currently in liquidation.

Under the receivership process, SBA as receiver retains independent contractors on a noncompetitive basis to operate the receivership, but in some instances, SBA staff operate the receivership. Receivership contractors are generally paid out of funds generated from the liquidation of the investment company's assets. With the permission of the receiver, the contractors

[3] Small Business: Financial Health of Small Business Investment Companies (GAO/RCED-93-51, May 5, 1993).

generally hire accountants, lawyers, auctioneers, and others needed to carry out the liquidation. All other creditors of the SBIC or SSBIC and all receivership expenses are paid before SBA receives any proceeds.

The receivership process can be lengthy, costly, and in some cases not financially beneficial because often SBA does not know the extent of the SBICs/SBICs financial strengths or the extent of other creditor at the time it must make a liquidation decision. Of the 71 SBICs currently in receiverships, 23 have been in receiverships for 5 or more years--2 have been in receiverships for over 25 years. One SBIC we reviewed was placed in receivership in April 1984 to recover SBA's investment (including interest) of $7.8 million. The receivership received an advance of $30,000 from SBA to conduct the receivership. The final receivership report submitted to the court in May 1993, showed that the contractor incurred cost of $103,900 and recovered $115,300, which left a net balance of $11,400--not enough to cover the $30,000 advance SBA made to the receivership. Most assets of this SBIC were found to be worthless or uncollectible. In another instance, a receivership contractor incurred $70,000 in expenses to liquidate assets of an SBIC that owed SBA over $1 million; the receivership recovered only $79,000.

Liquidation Can Occur Through Transferring Assets to SBA Involve Numerous Asset Write-Offs

SBICs and SSBICs that voluntarily assign their assets to SBA for liquidation account for $63.8 million, or 18 percent of all losses expected from the investment companies currently in liquidation. Under this approach, SBA assumes ownership of the investment company's assets in exchange for forgiving the outstanding debt owed to SBA. According to SBA officials, this approach is preferred when they believe the cost of liquidating through a receivership may outweigh the benefits.

Assigned assets often include unsecured notes and equity investments in small, closely held businesses, neither of which are readily marketable. In the case of securities, often the only course is to sell the securities back to the small businesses. SBA acquired 759 assets from 55 SBICs and SSBICs as of December 31, 1994. Of these assets, 529 have been identified as potentially having no value and may ultimately be written off as uncollectible.

According to SBA officials, SBA is not able to recover its funding from assigned assets because in many instances the assets are not worth as much as originally claimed by the SBIC and SSBIC or the assets no longer exist. Since SBA does not normally gain access to an SBIC's or SSBIC's financial records when asset assignments are made, it has no way of knowing whether the investment company fully disclosed all of its assets.

THE THREE PERCENT PREFERRED STOCK REPURCHASE PROGRAM

In November 1989, Congress authorized SBA to allow SSBICs to repurchase from SBA, at a price less than its par value, their outstanding preferred stock held by SBA.[4] In 1992, SBA announced the start of the Three Percent Repurchase Pilot Program, stating that the primary purpose of the program was to maximize the capacity of SSBICs to provide financing to businesses owned by persons whose participation in the free enterprise system is hampered by social or economic disadvantage. In addition, SBA stated that its policy was to be executed without providing windfall opportunities to SSBICs, their management or owners, and without encouraging the transfer of

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[4]In 1972, Congress authorized SBA to purchase 3 percent preferred stock from SSBICs at par value with no mandatory redemption requirement. The SSBICs were not required to pay SBA accrued dividends on this stock; although distribution to other shareholders cannot be made until those dividends are paid. On November 21, 1989, Public Law 101-162 authorized SBA to establish a repurchase program.

cash from SSBICs into SBA to the detriment of the program's effectiveness and liquidity.[5] As part of the pilot, SBA offered the stock repurchase program to nine SSBICs, six of which participated.

In April 1993, the then-Associate Administrator for Investment established a committee to evaluate the operation of the pilot so that the agency could establish final regulations to implement the program. The two major issues under discussion were the price of the repurchase and the eligibility of "non-distressed" or financially healthy, SSBICs for the program. The committee held its last meeting in June 1993. In September 1993, after the Administrator and other SBA officials met with industry representatives, the Administrator decided to go forward with the stock repurchase program and opened the program to all SSBICs without further input from the committee.

The terms of the program provide that all SSBICs can repurchase their 3-percent preferred stock at 35 percent of its par value and that only distressed firms would be forgiven the accumulated dividends at the time of the repurchase agreement. As of January 1995, 15 SSBICs (including the 6 in the pilot) had purchased $41 million in 3-percent preferred stock from SBA for $14 million. In addition, the 15 SSBICs were forgiven $14 million in accumulated dividends.

To date, neither we nor SBA has analyzed the financial operations of all the SSBICs that participated in this program and therefore we cannot determine whether the program has achieved its objective of generating new capital for investment in businesses owned by disadvantaged persons.

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[5] At the initiation of the pilot, it was estimated that approximately $153 million of 3 percent preferred stock was outstanding to 75 SSBICs, with accumulated dividends of approximately $35 million.

This concludes my prepared remarks. We look forward to continuing our work with the Committee. Madam Chair, we will be pleased to respond to any questions that you and other Members of the Committee may have.

TESTIMONY TO BE PRESENTED TO THE HOUSE OF REPRESENTATIVES SMALL BUSINESS COMMITTEE MARCH 28, 1995

Firstly, I would like to thank the members of this committee for allowing me to submit written testimony concerning the Small Business Investment Corporation (SBIC) program and our overall experience as a loan guarantor. My purpose in comparing the effectiveness of different SBA programs is to emphasize the unique ability of an SBIC to offer equity capital to small businesses which have few other options for capital.

Cal Coastal, founded in 1981, is one of nine non-profit corporations that are chartered and funded by the State of California to make loan guarantees and direct loans to small businesses. About sixty percent of our business are loan guarantees analogous to the SBA 7A loan guarantee program, except that a high percentage of our guarantees are to farmers and to businesses in need of a line of credit rather than a term loan. About forty percent of our activity is in the form of direct lending made with guarantees from the USDA loan guarantee program. Our lending is to companies which usually do not qualify for SBA financing. We are a lender/guarantor of last resort. Therefore, we feel that we have a lot of experience with loan guarantees that benefit small business.

Currently we are taking a lead role in creating an SBIC which will focus on small business investments within the Central Coast of California. We intend to use the Participating Securities program. Our partners are banks, pension funds, and small investors who desire to create a regional pool of investment capital. We have concluded from our fourteen years of lending experience, that too many small businesses are not well served by the multitude of loan programs that now exist nor by the venture capital companies which serve the high technology companies in California. For this reason we count on Congress to continue financing the SBIC program.

Many start-up businesses cannot find loan capital even with a public loan guarantee because lenders require both "hard" collateral and an operating history. Fast growing, entrepreneurial businesses are short of both hard collateral and operating histories. Working capital is invariably reinvested for growth and cannot be diverted to capital assets or paid out to owners in dividends. Many so called loans to such fast growing companies are really investments structured as loans. Loan amounts are typically less than ideal and principal repayments divert funds needed for growth. Neither the borrower nor the lender is well served when a loan is provided rather than a needed investment.

We would argue from our own experience that some guaranteed SBA credits serve loan clients that are able to get commercial loans. The ability of a lender to sell an SBA guaranteed loan at a premium results in tremendous competition among lenders to secure the SBA guarantee and provides a subsidy to the lender which rightfully belongs to taxpayers.

Because of underwriting requirements which favor hard collateral, very few start-up businesses get financing except under the newly created "Low Documentation" program.

Another argument which merits rebuttal is that the guaranteed loan programs leverage available tax funds further than does the SBIC program. SBIC's involve both private investment and full repayment by the shareholders of each SBIC. The loss to the taxpayer is from loans made to insolvent companies. In the recent revision of law, there are considerably more safeguards to insure full repayment. Capital requirements have been increased, SBA leverage is reduced on Participating Security, background checks are more thorough and management is put under more scrutiny than before. The new requirements insure lower defaults.

In addition to the SBA guarantee loan program, there are an array of State loan guarantors, Community Development Corporations, and Economic Development Administration financed revolving loan funds. There are relatively few program which provide equity capital rather than debt to smaller businesses.

A well balanced small business incentive program should have an assortment of programs that furnish both equity and debt for the benefit of small businesses. We feel that the SBIC program, especially the Participating Securities debentures, provide a necessary component for small business finance. If cuts are to be made to SBA programs, they should not target Small Business Investment Corporations.

Respectfully submitted by:

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March 23, 1995

Members
House Small Business Committee
U.S. House of Representatives
Rayburn House Office Bldg. - Room 2361
Washington, DC 20515

Ladies and Gentlemen:

This is to urge that your Committee recommend retention of the Small Business Investment Company Program under the Small Business Investment Act of 1958, and to expand the amount of leverage available for SBIC's to the full amount authorized by Congress in the Small Business Equity Enhancement Act of 1992.

I am a partner of a five lawyer law firm which represents almost exclusively small business concerns. I have practiced law for 35 years, and from 1960 to 1968 was counsel to a $45,000,000 SBIC in San Diego. During 35 years of practice, I have counselled many small businesses, particularly in their financial needs.

The importance of small business to the economy is undisputed: According to the Small Business Administration, there are approximately 20,000,000 small businesses in the United States which employ more than half of the domestic labor force, produce nearly half of the gross domestic product and are often the ones that develop new technologies, products and services. Almost all of the job growth in the last 20 years has come from small companies, as the Fortune 500 companies have, on balance, shed millions of jobs over this period. There is a direct relationship between the amount of equity capital available to small business and the growth of small business which in turn leads to development of new technologies, products and jobs.

The need in California for increased access to equity capital is acute. Governor Wilson has estimated that the state has lost over 800,000 jobs in the past four years. A study in 1993 by the Los Angeles County Aerospace Task Force estimated that Southern California has lost 170,000 defense/aerospace jobs since 1990 and will lose another 170,000 jobs in the next several years.

Page 2

A recent study (copy enclosed) by the Economic Development Corporation of Los Angeles indicates that the five county region of Southern California - Los Angeles, Orange, Ventura, Riverside and San Bernardino - lags far behind the rest of the state in equity capital available to high technology companies. The study showed that slightly more than 17% of the venture capital funds disbursed to California high tech firms over the past decade went to companies based in the five county region, as compared to more than 65% of such funds which went to Bay Area firms. The number of companies receiving venture funding decreased by 50% from 1983 to 1993.

According to a national survey conducted by Price Waterhouse of venture capital investments across the country totalling $1.5 billion, only $62 million or about 4% of the national total was invested in Los Angeles and Orange Counties in approximately 13 small businesses.[1] This compares with $379 million or about 25% of the national total invested in Silicon Valley.

This paucity of venture capital is in stark contrast to the greatest concentration of top national engineering schools, half of California's business support services and technological employment and 45% of the state's technical firm that reside in the five county Southern California region. For a region attempting to transition itself from a defense-based economy to a commercial-based one, venture capital is a key element in fueling this transition, and commercializing $ billions of defense/aerospace technology by small technology firms. Attached to this letter is an article entitled "The State of Venture Capital" by Rohit K. Shukla, Director of the Los Angeles Regional Technology Alliance which undertook the EDC study referred to above.

Congress recognized the need of small businesses for equity capital in 1958 when they adopted the Small Business Investment Act. The venture capital industry was substantially expanded by the 1958 Act, and many SBIC's were formed in the 1980's and early 1990's.

SBIC's tend to fill a gap of equity capital for small business concerns that are unable to obtain financing from the institutional venture capital industry which only invests in a very small segment of small business.[2]

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[1] The SBA estimates that total investments by California SBIC's were only $97 million in 1993 and $105 million in the first nine months of 1994.

[2] A partner of a leading venture capital fund in Northern California, in answer to a question from Louis Rukeyser on "Wall Street Week" as to how many companies his fund looked at versus invested in, indicated that they reviewed

Page 3

Unfortunately, the SBIC industry fell into dispute in the 1970's and 1980's, largely because of the mismatch of borrowed money on the one side, and long-term equity investments on the other, rendering those SBIC's unable to repay SBA loans and producing insolvencies for many SBIC's. Also, too many SBIC's were minimum capital SBIC's that did not have enough funds to retain competent managements.

These problems were remedied with the Small Business Equity Enhancement Act of 1992. According to the enclosed Wall Street Journal article, these companies have raised nearly $600,000,000 of private capital.

The new SBIC program has breathed new life into the small business community in the United States, and has generated new hope for a major increase in growth capital to develop new technologies, products and jobs.

For these reasons, I strongly urge your committee to favorably consider continuing the SBIC program and expanding the amount of leverage available to these SBIC's in the full amount authorized by Congress in the 1992 amendments.

Very truly yours,

PETILLON & HANSEN

Lee R. Petillon

LRP:ml
Enclosure
cc: Hon. Jane Harman, Congresswoman, 36th District, California

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about 1,000 proposals a year, and invested in between 10 and 20 companies. It is the other 990 or 980 small companies for whom the SBIC industry could provide equity financing. These companies may not be the Intel's or Apple's, but could provide many thousands of jobs and add to California's economy.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

Honorable Jan Meyers
Chairman
Committee on Small Business
House of Representatives
Washington, D.C. 20515

Dear Madam Chairman:

During the March 28 House Small Business Committee hearing on the SBIC/SSBIC program, several issues were raised to which SBA indicated it would provide additional information. First, Congressman Fattah noted that there appeared to be a great disparity between the SSBICs debt-to-equity ratio as compared with that of the SBICs, i.e., that the SSBICs seemed to have a much greater level of SBA-guaranteed leverage relative to their private capital than the regular SBICs.

Separately, you inquired as to the discrepancy between the amount of leverage in liquidation as reported by SBA and the GAO. The GAO quoted a figure of $790 million exposure and a possible $443 million recovery, or a potential loss of $347 million, while SBA reported a potential future loss of $253 million.

To clarify the issue raised by Congressman Fattah, we are enclosing a summary which provides a breakdown of the private capital and outstanding leverage for the regular SBIC program and the SSBIC program. As indicated at the hearing, a significant portion of the noted disparity can be attributed to the fact that the regular SBIC program includes the bank owned SBICs which use little to no leverage and represent approximately two-thirds of the total private capital in the regular program.

Additionally, the substantial growth in private capital among non-bank SBICs that was experienced during Fiscal year 1994 took place so late that these new licensees had no leverage at year end. Finally, the regular SBICs, in general, are more highly capitalized than the SSBICs and have indeed used less leverage. The comparison of leverage of SBICs licensed before Fiscal 1994 (69% of private capital) with comparable SSBICs (141% of private capital) is not as dramatic a contrast as the overall statistics would suggest. Further, it should be noted that both of these ratios are substantially below the maximum of 300% that is allowable under the program.

Regarding the SBIC/SSBIC program losses, the GAO testimony dated March 28, 1995 entitled, "Status of Small Business Investment Companies" states, "Of the 192 SBICs and SSBICs currently in liquidation, owing $790 million to SBA..." This refers to the level of leverage at the

time these companies were transferred to liquidation, whereas the SBA figure of $522 million referred to the amount of leverage of these companies still uncollected as of December 31, 1994. The difference is that $169 million had been collected and paid to SBA, and $99 million had been charged-off by December 31, 1994.

We expect to collect an additional $269 million of the balance outstanding December 31 (and indeed have collected $30 million so far this year), bringing the total collections to $438 million, or 55% of the original $790 million transferred to liquidation.

We will be pleased to answer any additional questions you may have regarding these matters.

Sincerely,

Robert D. Stillman
Associate Administrator
for Investment

SUMMARY OF SBICs IN OPERATIONS
as of June 21, 1995

	Number of SBICs	Private Capital	Leverage from SBA	Leverage as % of Private Cap.
Regular SBICs:				
Bank Owned	62	$1,837,230,514	$ 26,500,000	1.4%
Non-Bank Owned:				
Licensed- Pre FY 1994	79	$ 579,290,707	$401,642,910	69.3%
FY 1994-95	42	$ 613,889,534	$168,340,000	27.4%
Total Regular SBICs	183	$3,030,410,755	$596,482,910	19.7%
Specialized SBICs:				
Bank Owned	4	$ 3,510,000	$ 5,450,000	155.0%
Non-Bank Owned	87	$ 192,532,337	$271,428,917	141.0%
Total Specialized SBICs	91	$ 196,042,337	$276,878,917	141.0%
Grand Total of All SBICs	274	$3,226,453,092	$873,361,827	27.1%

VENTURE CAPITAL AND TECHNOLOGICAL INNOVATION IN SOUTHERN CALIFORNIA

AN EXAMINATION OF THE STATE OF VENTURE CAPITAL AND METHODS TO INCREASE TECHNOLOGY VENTURES

A Study by
The High Technology Council of
The Economic Development Corporation of Los Angeles County

in cooperation with
The Los Angeles Regional Technology Alliance

FORWARD

From entrepreneurs to economic development officials, many in the Los Angeles region have complained about a "capital gap" — a paucity of patient capital necessary to nurture high-technology industries.

This study addresses this "capital gap" by examining the state of venture capital. The Economic Development Corporation of Los Angeles County performed this study under a grant from the U.S. Economic Development Administration. The author is Cliff Numark, MSc., and Master in Public Affairs candidate at Princeton University's Woodrow Wilson School.

The study performs three functions. First, it examines the region's technology base. Second, it assesses the state of venture capital in the region. Third, it recommends policy measures to enhance high-technology entrepreneurial activity, while reporting the region's nascent efforts to speed financing of high-tech ventures.

EXECUTIVE SUMMARY

The southern California five county region[1] (the region) hosts half of California's technological employment, 45 percent of the state's technological firms, four of the top national engineering schools, a significant amount of research and development funds, and more than half of California's business support services.

Despite this wealth of high-technology resources, the region has never attracted venture capital commensurate with its technological strength; over the past decade, of all California companies receiving venture capital, less than 20 percent were located in the region (at least 65 percent were in the Bay Area). In 1993, the region's lackluster venture capital record reached new lows. For southern California entrepreneurs, 1993 was the worst year for venture capital in the past decade.

Using previous and original research, this study revealed the following findings on venture capital in the region:

1. The number of venture capital investments steadily declined in the 1990s, reaching a ten-year low in 1993. That year, venture capital firms invested in just 70 companies; in 1983 they invested in 142 companies. This is worse than the national trend.
2. As a percentage of California venture capital investments, the region's receipt is the lowest in ten years. In 1993, just 17.4 percent of venture capital invested in California was funneled toward the region; in 1983, that figure was 29.5 percent.
3. Although the amount of early stage funding increased in 1993, the number of companies receiving it reached a new low. Just 13 companies

[1] The five counties are Los Angeles, Orange, Riverside, San Bernardino and Ventura.

received seed or startup venture capital funding in 1993; in 1983, 33 companies received early stage capital.

4. There are less than 35 active venture capital firms with capital under management in the entire region; this represents little more than one-fifth of all California venture firms. By comparison, one street in Silicon Valley, Sand Hill Road, hosts more than 35 active venture firms.
5. The biotech, software, and medical/health care industries received the most venture investment. Information technology, other electronics and consumer-related goods played smaller, though significant, roles.

Though some bright spots exist — one southern California venture firm, with half its investments in the region, raised a new $112 million fund in eight days — the broad picture of the region's venture capital community and investments is a poor one indeed.

This study concluded that the region has barriers to venture capital-based technology development. First, the region's large size (larger than 41 states) impedes venture capital and industrial network development. Second, an unfounded perception exists that the region lacks entrepreneurial fire. Finally, venture capital activity is low relative to the region's technology base because the defense industry absorbed a disproportionate amount of the technological talent; bright technologists worked for defense firms that venture capital investors traditionally avoid.

With core defense industries absorbing half of the region's technology employment, the defense drawdown will continue to damage the region's technology base. Already, the drawdown cut the number of Los Angeles

county aerospace/high-tech jobs by nearly half its peak 1987 levels.[2] These trends will likely continue as the U.S. Defense budget is expected to fall by 17 percent — from $273 billion in 1993 to $227 billion in 1997 — after being reduced by 29 percent from 1985 to 1993. (Bitzinger: p. 3) So, federal defense spending will continue to provide less capital for the region's economic and technological growth.

Opportunity, however, exists in this adversity. Some of the region's technological talent — and certainly its new technology graduates — can be re-focused in more entrepreneurial ventures. But the region will need venture capital, as a substitute for defense funds, to continue advancing the region's technology.

For this venture capital-based technology development to occur, this study recommends the following policy measures:

1. Entrepreneurial training that can teach technologists basic business skills, which develops a management infrastructure for technology ventures.
2. Venture capital investor activities that encourage investor interaction, which develops a capital infrastructure for technology ventures.
3. Database services that can "match" the investor community with the entrepreneurial community.
4. A privately-managed public/private fund, such as a small business investment company, that can invest in worthy local ventures and attract other private venture capital to the region.

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[2]EDC analysis of California Employment Development Department Data. These figures are for the EDD's standard definition of aerospace/high-tech, which does not include such SIC codes as drugs, medical distribution and ophthalmic goods.

SECTION I: INTRODUCTION AND RESEARCH METHOD

Many factors influence the development of a commercial high-technology economy, including a skilled labor force, a pool of technology firms, and adequate business services.

However, venture capital is a linchpin to commercial high-technology development. Entrepreneurs, often with no revenue history, have difficulty obtaining conventional financing. Entrepreneurs' own funds may sustain their ventures in the initial stages, but to expand into full production development, they will often need an infusion of outside capital — venture capital.

In the nation's premier high-technology community, Silicon Valley, venture capital propelled high-technology development. Along with other factors — such as a skilled labor force, business support services, and technological firms — venture capital fueled the growth of technology.

This history contrasts with Los Angeles' technological growth. The region's technological base, about half of California's, was fueled by defense spending. During World War II, Los Angeles became a focal point for the aircraft industry, and after the war, electronics and missile manufacturing developed in the region. Department of Defense contracting rose steadily, starting in the late 1970s, boosting the area's economy and technology. Aerospace is a major force in the region's technology. Two years ago, the Aerospace Task Force, led by the Economic Development Corporation of Los Angeles County, commissioned a major study of the Los Angeles County defense industry. The report's author, the public policy organization the Economic Roundtable, reported that the Department of Defense purchases 51.2 - 65.1 percent of the county's high technology industrial sales. (Economic Roundtable: 76)

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To convert into a commercial high-tech economy while continuing the development of the region's technology base, the region will need venture capital.

To determine exactly how much venture capital is present and to examine the region's technology base, this study relied on the following methodology:

In assessing the state of the region's venture capital investment and supply, this study relies heavily on the work of Don Smith at RAND and Richard Florida at Carnegie Mellon University, two researchers who have done extensive econometric work on venture capital and location. Securities Data Company also provided data not previously released. This information, combined with other published studies, complements the study's original research. As part of the original research,

- California venture capital investments were analyzed from 1988 to 1991 using reports in Venture Capital Journal, which reports about 40 percent of all investments made.
- The characteristics of southern California venture capital firms were revealed through a telephone survey of regional firms listed in Pratt's Guide to Venture Capital Source; 40 of 54 contacted firms responded to the survey.
- The trend in southern California venture firm offices was revealed by analyzing information in Pratt's Guide to Venture Capital covering the period 1986 - 1993.
- The trend in the five counties' high technology and business services was revealed through an analysis of the U.S. Census Bureau's County Business Patterns.

• More than 20 academics, economic development officials, pension personnel and members of venture capital firms were interviewed to provide qualitative information for the findings.

With this information, and data from past studies, this study examines the state of the area's venture capital and proposes methods to increase innovative ventures. The first section discusses the relationship between venture capital and innovation. The second section examines the supply, flow and investment of venture capital. The third section analyzes the area's technological base. The final section recommends policy measures — and discusses current activity in the region — to increase entrepreneurial technology-based ventures.

SECTION II: VENTURE CAPITAL AND INNOVATION

Venture capital is a necessary, but not sufficient, component for technological innovation.

Two major models of technological innovation exist: innovation through entrepreneurial firms and innovation through established R&D facilities at large companies. These models may be complementary; large companies and academic institutions may develop raw technologies that flexible entrepreneurs bring to market as products.

Venture capital investors can be viewed at the crosspoint of the innovation process, examining the technology and market demand — and then determining funding (Florida and Kenney: 127-129). Venture capital investors, then, occupy a "nodal position" in what researchers Richard Florida and Donald Smith have termed the "social structure of innovation" that consists of the following factors:

- well-developed networks of innovators
- skilled and adaptable labor force
- concentration of technology-intensive enterprises
- dense venture capital networks
- public and private R&D
- efficient system of information and technology transfer
- business support services (Florida and Smith(iii): 356)

In the development of the nation's premier technological complex, Silicon Valley, all factors were present. In the 1940s and 1950s, electronics and electrical firms were drawn to the Bay Area's emerging aircraft and space industries, the only customer for semiconductors for many years (Dorfman: 312). Initially, many of these early entrepreneurial electronics firms relied on traditional corporate and financial institutions: Beckman Industries backed Shockley Transistor Corporation, and Fairchild Camera funded Fairchild Semiconductor (Florida and Kenney(ii): 310).

In the early 1960s, some rudimentary venture firms were founded. Then, in the late 1960s and early 1970s, the venture industry surged; East Coast venture firms opened Bay Area branches, and nearly 30 new venture operations were established between 1968 and 1975. Between 1978 and 1982, the industry surged again, with more than 50 funds founded. This growth was boosted by a capital gains tax cut, pension funds' new presence in venture investing, and success stories, such as Intel and Apple. (Florida and Kenney(ii): 311)

In examining the evolution of leading technology complexes, researchers have found a venture capital shift: "whereas venture capital originally came from outside these complexes, it later became a central element of them." (Florida and Smith(ii): 438) Nationally, there is a high correlation, greater than .85, between the number of venture capital offices and the number of high technology firms. (Florida and Smith(iii): 355)

Though venture capital is an integral part of developing a regional technology base, it will not meet the needs of all areas. First, technology alone will not draw venture capital or develop an entrepreneurial culture. Even areas with high technology, such as North Carolina's Research Triangle, have failed to develop a self-sustaining entrepreneurial culture. (Florida and Kenney(ii): 317)

Second, though the total venture capital under management has grown from $5.7 billion in 1978 to more than $33 billion in 1993[3] (Pratt, 1993: Preface, VC Journal May, 1994: 39), it is still a fraction of the total capital available from corporations, lending institutions, and the federal government.

Nevertheless, venture capital is important for technology-based, high-growth entrepreneurs. In an examination of new technology-based firms founded between 1975 and 1986, the Center for Venture Research at the University of New Hampshire, found that 62 percent raised funds from outside equity investors: of these, 70 percent raised funds from private individuals and half raised funds from venture capital firms.[4] (Freear and Wetzel(ii): 77)

Venture capital firms do not just provide funds, they can add value. Often, they provide frequent detailed feedback on firm plans, assist in selecting the venture's management team, design business plans and strategy, and aid in setting managerial systems and controls. (Ehrlich, De Noble, et al: 68; Sapienza:22)

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[3]All dollars are in 1987 constant dollars. Figures were adjusted for inflation using the implicit price deflators for non-residential fixed gross private domestic investment , as supplied by the Bureau of Economic Analysis.

[4]Though the trend is similar, this study's results vary from an analysis of "emerging growth business" (which may not be technology based). In that analysis, venture capitalists provided 15 percent of capital to emerging growth businesses; individuals supplied 35 percent, corporations supplied 25 percent, federal SBIR (small business innovation research) grants provided 15 percent, and state and local grants supplied the remaining ten percent. (Gupta, Udayan. p. B3)

This value-added is demonstrated in the performance of venture-backed companies. A series of University of Santa Clara studies found that entrepreneurs receiving outside capital had sales growth of 157 percent and employee growth of 77 percent, compared to 48 percent and 35 percent that did not receive outside capital. (Bruno, Tyebjee: 61) Similarly, Coopers & Lybrand's *Fourth Annual Economic Impact of Venture Capital Study* found venture-backed companies created significant skilled jobs. Skilled jobs represented 55 percent of all jobs produced by venture-backed firms. In the U.S. as a whole, skilled jobs made up just 14 percent of all jobs created. (Coopers & Lybrand: 11)

Finally, venture capital, by purchasing equity rather than debt, allows small ventures to re-invest profits, avoiding scheduled repayments. (Florida and Kenney: 121) Even if firms can make the payments, conventional financing is often difficult because they lack a revenue history. In fact, small business loans have declined substantially: in the past decade, bank loans to small companies have fallen by more than 40 percent, while loans to large firms increased by the same percentage. (California Industrial Development Financing Authority: 8) A study of economic development loan programs reported that 96 percent find small businesses have credit needs that the lending programs cannot meet, especially in start up and early stage businesses. (The Development Fund: 3)

Section III: Venture Capital and Location

Close geography aids venture capital investing.

Although venture capital, like all capital, should flow freely, the industry is "characterized by high levels of uncertainty, high risk and ambiguous information." (Florida and Smith(iv): 16) Such uncertainty is

minimized, risk is reduced and information is increased with an increase in geographic proximity.

First, close geography helps venture capital investors find entrepreneurs from referrals by accountants, lawyers and other venture capital investors who "pass" on the deals. Brent Rider, a general partner of El Dorado Ventures, said he reads blind business plans sent to the firm, but rarely funds them. "That's a very weak source of deals for us," Rider said. "Companies of quality find a way to get introduced to us."

Second, as noted earlier, venture capital investors can provide guidance for new ventures, especially at the early stages. Venture capital investors may write entrepreneurs' business plans, serve as CEOs, or provide office space for their growing businesses. Close oversight allows venture investors to reduce their risk.

Finally, venture capital investors often reduce their risk by co-investing with other venture capital investors: one survey, for example, found that approximately 90 percent of all venture capital investments involve co-investment partners (Florida and Smith(iv): 18). In California, these co-investors are close to home — 40 percent of California venture capital investors co-invest with other California venture capital investors. (Florida and Smith(iii): 353)

This section will examine venture capital in the region. First, it will will examine the region's supply of venture capital and where this venture capital flows. Next, the section will examine the orgination of venture capital investments in the region and then detail the number and amount of investments. Then, the section will describe regional venture capital investments by financing stage and discuss seed and start-up capital. Finally, the section will outline venture capital investments in various industries.

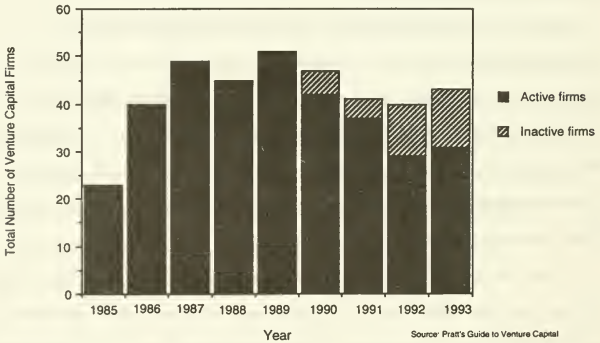
VENTURE CAPITAL SUPPLY

Regional firms maintain about a third of California's capital under management; the number of active firms grew rapidly in the mid-1980s and declined rapidly in the 1990s to less than 35 active firms today. There are more than 100 Bay Area venture capital firms.

Nationally, venture capital is concentrated in three metropolitan statistical areas (MSAs), Boston, New York City and San Francisco. These areas jointly account for approximately 60 percent of the nation's venture capital supply, about $33 billion. (Florida and Smith(iii): 348)

California's capital under management has increased in the last ten years, from $3.8 billion in 1983 to $8.0 billion — about 24 percent of the nation's total pool — in 1993. (Venture Capital Journal, June 1985: 12, May

Figure 1. Venture Capital Offices in the Region



1994: 39). Los Angeles firms and branches maintain about a third of California's total, approximately $2.7 billion under management.

The number of venture fund offices, as well as the amount of funding, has increased in California. Reflecting California's growing venture capital community, the number of venture capital firms increased 149 percent from 1973 to 1987 (Florida and Smith (iv): 22). About 22 percent of the nation's venture firms are in California.

However, little more than one-fifth of California's active firms are in the five county region. (VC Journal, May 1994: 39) Now, less than 35 active firms are present in the region. By contrast, in the Bay Area, there are more than 100 active firms; there are more active firms on one road, Sand Hill Road, than in the entire five county region. Figure 1 shows how the number of regional offices with capital under management grew rapidly, from 1985 to 1987. [5] During the recession, the number of active offices declined just as rapidly, with a 25 percent decrease in active firms from 1991 to 1994.

FLOW OF VENTURE CAPITAL OUT OF THE FIVE COUNTIES

Venture capital firms present in the five-county region invest in equal amounts in Bay Area and five-county companies; more than 40 percent of their investments are made out of state.

Nationally, researchers Richard Florida and Don Smith, examined investments during the period 1983 - 1987 and found that capital flows into high technology areas. For example, 26.6 percent of New York's venture capital investments were made in the San Jose metropolitan statistical area (MSA), as were 18.3 percent of Boston's investments. More than 60 percent of California's investments remained in-state. (Florida and Smith(ii): 440)

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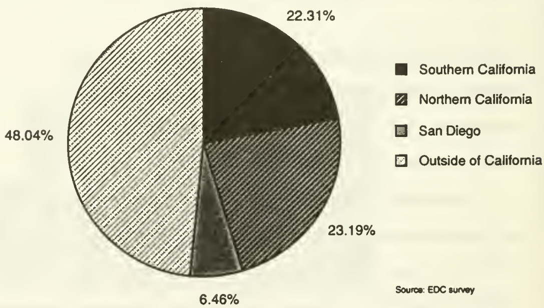
[5] **Figure 1 accurately represents the trend in venture capital offices, but these offices may differ greatly, with capital under management ranging from $1 million to $1 billion. Prior to 1990, there was no distinction between active and inactive venture capital firms.**

For Los Angeles venture capital investors, the researchers found a near even distribution between the Bay Area and southern California: 28.3 percent of total investments, were in the Bay Area (San Jose, San Francisco, and Oakland MSAs), while 24.6 percent were made to the southern California region (Anaheim and Los Angeles MSAs). (Florida and Smith(ii): 440). About six percent of their investments were made to the San Diego region.

This concurs with our survey of venture capital investors in the five county region. As shown in Figure 2, about 23 percent of their investments were made in the five-county area and northern California. The largest percentage of investments, 48 percent, were made outside of California.[6]

Figure 2. Investments by Southern Californian Venture Capital Firms



[6]These figures include venture firms with branch offices in southern California but headquarters located outside the region. Most of the firm headquarters were in the New York and Boston areas.

FLOW INTO THE FIVE COUNTY REGION

Bay Area, Los Angeles and New York venture capital firms make the most investments in five-county companies.

Venture capital flows into the region from sources across the country. However, according to Florida and Smith's study, Bay Area, Los Angeles and New York firms made the bulk of investments into southern California, as represented by the Los Angeles and Anaheim MSAs. As shown in Table 1, San Francisco and San Jose venture firms made 19.9 percent of all investments into the region in 1983-1987. A total of 26 percent of southern California investments were supplied by Los Angeles and New York venture firms. (Florida and Smith(ii): 440)

Table 1. Investments into Southern California

MSA Source	% of LA Investment
San Francisco	16
San Jose	3.9
Los Angeles	13
New York	13.2
Boston	8.9
Chicago	5.2

source: Florida and Smith, p. 44

VENTURE CAPITAL INVESTMENT — AMOUNT AND NUMBER OF INVESTMENTS

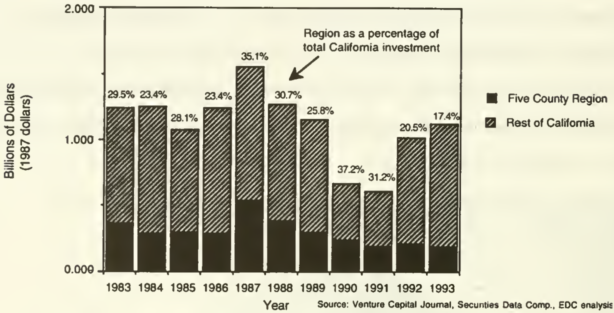
The number of investments in the region is the lowest in ten years, less than 30 percent of the 1987 peak. As a percentage of California investments, the amount of investment in the region is the lowest in ten years.

AMOUNT

Over the past ten years, California has received the largest amount of venture capital of any state. In 1993, 361 California companies received $1.1 billion, 38 percent of the total amount invested that year (Venture Capital Journal, June 1994: 35). As shown in Figure 3, the actual amount invested in California peaked in 1987 and is now at a level close to that in 1983.

The amount invested in the five county region mirrors this statewide and national trend, as can be seen in Figure 3. Although the amount invested in the region reached its nadir in 1991 (just $191 million was invested), the region — as a percentage of California investment — has never been worse off. In 1993, 70 companies in the region received $195 million.

Figure 3. Amount of Venture Capital Invested in California



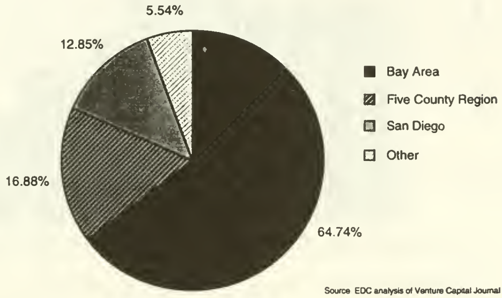
This is less than 17.4 percent of the total amount invested in California, a sharp drop from the 35 percent figure achieved between 1987 and 1990.

Number of Investments, Relative to Rest of State

From 1982-1987, the majority of California investments were made in the Bay Area. In Smith and Florida's location data, they found that the Silicon Valley received 531 of 702 California investments, or 75 percent of the total. In that time period, only 14 percent of the investments were made in the Los Angeles region, defined by the Los Angeles and Anaheim MSAs. (Florida and Smith(ii): 441)

Similarly, in the EDC examination of California venture capital from 1988-1991, the vast majority of investments went to Bay Area companies. Of the 397 companies examined in that period, 64.7 percent were in the Bay Area.

Figure 4. California Investments, 1988-1991



Nearly 17 percent of invested companies were in the five county region, while 13 percent were in San Diego, as shown in Figure 4.[7]

NUMBER OF INVESTMENTS

In 1993, fewer companies received venture capital than at any time in the past decade. Figure 5 shows that in 1993 just 70 companies received venture capital; this is half the 1983 level, and less than 40 percent of the 1987 peak.

These regional statistics far exceed national trends — at the low point in 1991, the number of companies receiving venture capital nationwide was

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[7]As in the work done by Florida and Smith, Venture Capital Journal, the primary publication of the Venture Capital Industry, was examined from years 1987 to 1992. The reported investments represent about 40 percent of total investments.

64 percent of 1983 levels and 45 percent of the 1987 peak period.

Figure 5. Number of 5-County Companies Receiving Venture Capital

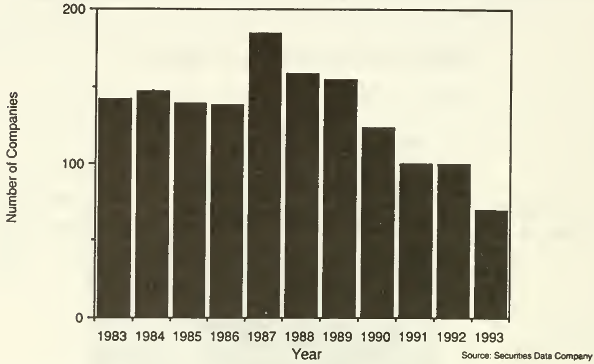
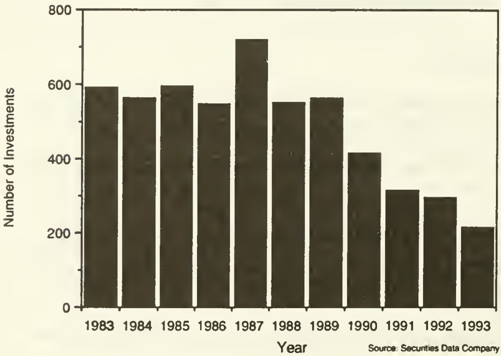


Figure 6. Number of Venture Capital Investments in Five County Region



In 1993, fewer venture firms made their investments in the region than at any time in the past decade. Figure 6 shows a trend that mirrors Figure 5. But the results are even worse — the number of 1993 investments, 217, was little more than a third of the number of 1983 investments.

The low amount of venture capital, its paucity relative to the rest of the state, and the absolute low point in number of companies receiving venture capital — all indicate that the region is not attracting venture capital.

VENTURE CAPITAL INVESTMENT — BY FINANCING STAGE

Seed and startup funding has declined over the past decade; just 13 companies received seed or startup money in 1993.

The venture capital statistics covered in the previous section merge different stages of investment. Venture capital can be considered in its financing stages, often with the following definitions shown in Table 2.

Table 2. Venture Capital Financing Stage Definitions

Seed	small amount of capital to prove a concept.
Startup	for product development and initial marketing. No commercial products.
First	companies ready for full-scale manufacturing and sales.
Expansion	for initial or major expansion.
Acquisition/LBOs	acquiring companies through leveraged buyouts or other means.

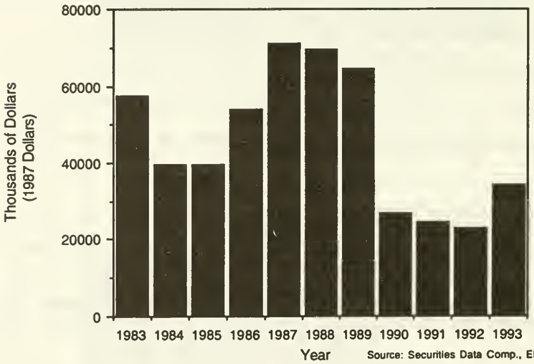
source: Pratt's Guide to Venture Capital, p. 124

Nationally, seed and startup investment has declined in real dollars since 1988. (Venture Capital Yearbook: 36) However, the amount of seed and startup funding has held steady as a percentage of total venture capital investment, between 10 to 12 percent. Other areas, such as LBO/acquisitions, have experienced a huge decline, falling from 29 percent of all venture capital investments in 1988 to 6.9 percent of venture capital investments in 1992.

For the southern California region, seed and startup funding by venture capital is slightly higher than the national average, representing about 15 percent of the amount of venture capital and 19 percent of the number of venture capital investments over the past 10 years.

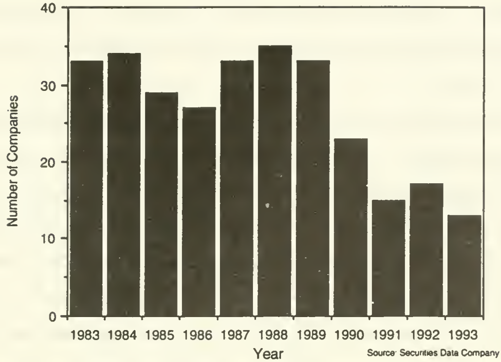
Nevertheless, Figures 7 and 8 show that the level of seed and startup investments, both in number and amount, has declined steadily. Although the amount of early stage money is picking up as seen in Figure 7, the number of companies receiving it is not — just 13 companies received seed or startup money in 1993, compared to 33 a decade ago, as shown in Figure 8.

Figure 7. Amount of Seed and Startup Investments in Five County Region



Source: Securities Data Comp., EDC analysis

Figure 8. Companies Receiving Seed & Startup Venture Capital



These results confirm more recent data: in Coopers & Lybrand's *Venture Capital Questionnaire* of Los Angeles investments for the first three months of 1994, none of the 18 reported investments were made before the first stage. Venture capital investors are not optimistic about continued seed investment in the region: "Three years ago there were 25 people in early stage technology," said Brent Rider of El Dorado. "Now there are five."

This sentiment is voiced nationwide. In the National Census of Seed Capital Funds, 82 percent of seed capital fund managers believed a seed capital gap existed; 71 percent of the managers believed the gap would widen in the next three years. (Meyer: 17)

DIFFICULTIES WITH SEED/START-UP CAPITAL

Early stage deals are riskier, take more time and are difficult to manage. "Angels" often invest in the very early stage.

Many analysts and policy makers focus on seed and startup funding because this is the stage that can launch new technologies. Nevertheless, venture capital investors are reluctant to invest in seed/startup deals for four primary reasons:

1. Greater risk. As new ventures, seed/startups present high risks. Often the ventures have no track record as firms, commercial products do not exist, and the market has not tested their success. In the Census of Seed Capital Funds, 70 percent of the failed investments were in the seed/startup stage. (Meyer: 13) Sixty-two percent of all new ventures are extinct within six years. (The Development Fund: 6)

2. High time requirement. Many venture capital investors may shy away from seed/startup because of the required time investment. In an examination of seed capital, Venture Capital Journal reported that "typically a general partner will serve as CEO for 6 to 12 months." (Venture Capital Journal April 1989: 13) Venture capital investors rewrite business plans, define the market, establish distribution channels, form sales strategies, and devise marketing strategies. They help jump-start the firm.

3. Prudent Investment Rules. Pension funds represented 41.6 percent of all private funds in 1992, rising from 33 percent in 1982. (Venture Capital Yearbook: 24) The pension funds have increased the size of venture firms; one Los Angeles-based fund, for example, receives all of its $75 million in funding from the California State Teachers Retirement System.

As funds increase to this size, relatively smaller investments for early stage ventures are difficult to handle. Consider a venture firm with $100 million under management. If the firm only makes seed deals, which average $500,000, the partners must monitor 200 companies, a trying task.

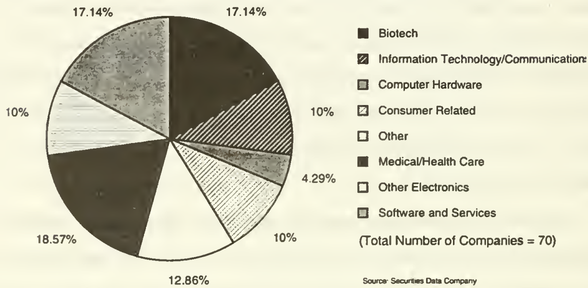
In fact, firms interested in early-stage ventures will often invest in a select number of companies, and then nurture them for years. Researchers John Freear and William Wetzel found that venture firms do not scatter their investments across multiple early stage ventures. Instead, they nurture their initial investments by continuing to invest in them in larger amounts in later stages. About two-thirds of venture investments are additional support for companies already in a venture firm's portfolio. (Freear, Sohl, Wetzel(i): 7) This meshes with the results of our survey that indicated that of the companies in their portfolios, 222 out of 534 companies (41.6 percent), were *first* funded at the seed or startup stage; much of these companies continue receiving investments.

Freear and Wetzel found that for early stage ventures under $500,000, entrepreneurs should seek out private "angels," high wealth individuals who can provide initial capital and prepare the company for larger amounts of venture capital in later stages. Though exact numbers are difficult to obtain, a conservative estimate is that 250,000 active angels invest about $10 billion nationally in 30,000 ventures per year. (Freear and Wetzel(ii): 80) These angels invest in smaller amounts, but *more* often and in *more* firms, than venture capital firms; a typical venture capital investment was $1-3 million, while an angel investment was often under $500,000. (Freear and Wetzel(ii): 86) Thus, angels and venture capital firms complement each other; angels may take the initial risk with the early stage ventures, and then make the venture ready for substantial funding from venture capital firms. (Freear, Sohl, Wetzel(i): 8)

<u>INVESTMENT BY INDUSTRY</u>

Venture investors targeted biotech, medical/health and software companies in the region; other electronics, consumer-related and information technology companies were less targeted.

Figure 9. Companies Receiving Venture Capital by Industry — 1993



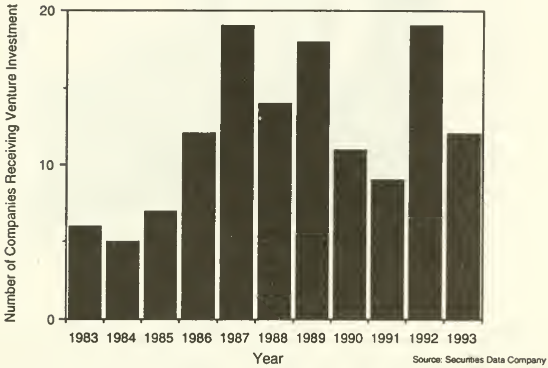
In general, venture capital is focused on technology enterprises, and all but one Los Angeles venture firm surveyed invests in technology enterprises. Figure 9 aggregates all firms receiving venture funding; the dominant industry receiving venture investment is medical/health care, with biotech and software a close second. Taken together, these three industries comprise 52.8 percent of companies receiving venture capital, according to the Securities Data Company.

Figures 10 - 14 show the trend in the major technology areas in the five-county region.

In Figure 10, we see the steady rise during the 1980s of biotech companies receiving venture funding. Despite the recession, venture firms

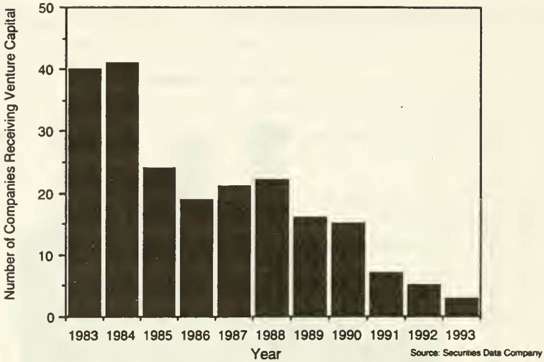
continued to invest in the region's biotech companies; in fact, in 1992, 19 biotech firms received venture funding, equaling the venture peak in 1987.

Figure 10. Biotech



In Figure 11, we see the decline in hardware as an object of venture deals. Though the dominant player in the early 1980s — it represented nearly 30 percent of all companies receiving venture funding in the region — venture funding for hardware companies declined rapidly during the eighties. Now, it is one of the least significant industries receiving venture funding.

Figure 11. Computer Hardware



In Figure 12, venture investment in medical/health care followed the national trend in venture capital, peaking in 1987. Although the number of medical/health care firms receiving venture money is little more than half the 1983 level, the industry still attracts the most venture capital, $36.3 million in 1993.

In Figure 13, software shows a similar pattern. As a percentage of the firms receiving venture funds, the software companies declined to about 11 percent from 1986 to 1991. Now, software companies represent a greater share, 17 percent of all companies receiving venture funding. Also, the industry netted $36 million in 1993. Nevertheless, like health care, venture capital was invested in half the number of companies as a decade ago.

Figure 12. Medical/Health

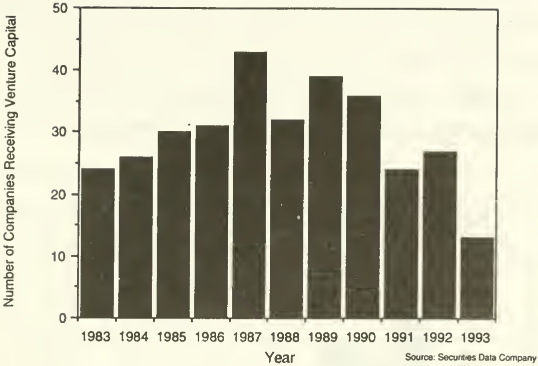
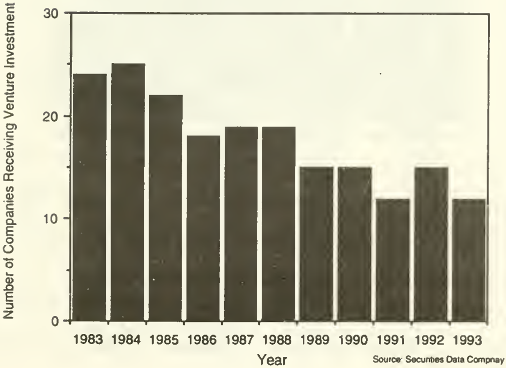
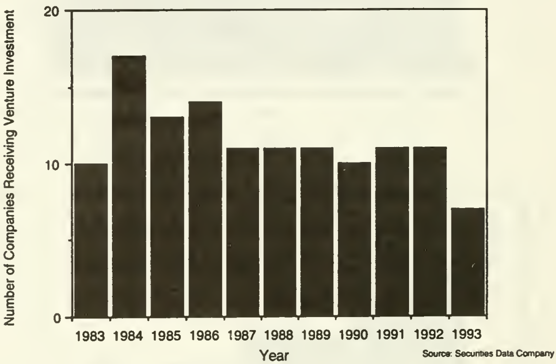


Figure 13. Software



The number of communications companies — both commercial and telephone/data — receiving venture funding has remained steady through most of the ten year period, at about 11 companies per year as shown in Figure 14. Over the past few years, this figure has gradually increased in importance, representing about 10 percent of all companies receiving venture funding.

Figure 14. Information Technology (Communications)



Venture capital investors who were interviewed said investment prospects in the five county region are good in biotechnology, medical/health and information technology, especially as communications technology merges with entertainment media. Some believed that certain portions of aerospace/defense could be spun out for commercial ventures, though others were less optimistic.

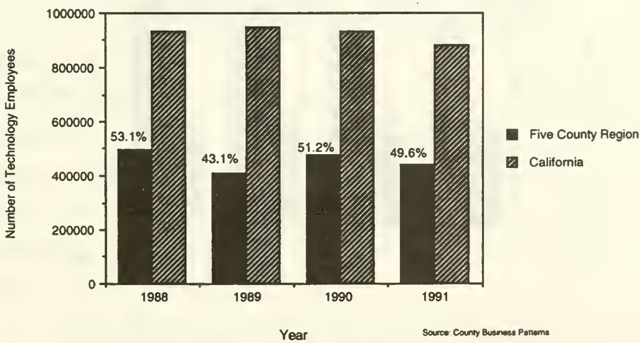
SECTION IV: THE REGION'S SOCIAL STRUCTURE OF INNOVATION

The region represents half the state's engineers, half the state's business support services, 40 percent of the state's technology firms, four top engineering schools, and significant research and development. However, about half of the technology employment and enterprises are defense-related.

Technology development is not formulaic. Nevertheless, certain factors must be present to spur technological growth. The five county region has many of the building blocks — a large technological labor pool, a large number of technology-oriented firms, significant R&D by local universities and excellent business support services — necessary for growth.

As shown in Figure 15, the five county region consistently represented half of the state's employment in technology enterprises through 1991, including communications, computers, aerospace, medical industries, electronics parts, and commercial research. According to the last accurate

Figure 15. Technology Employment

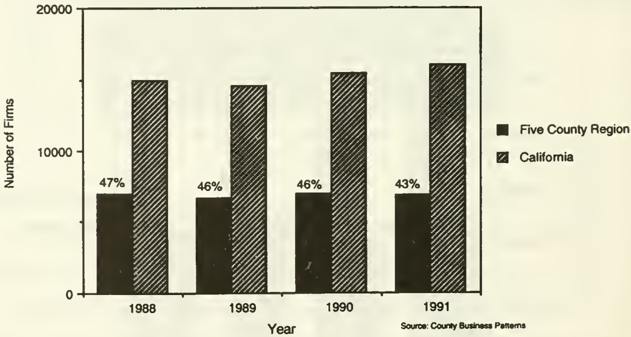


measure, there are more than 439,000 technology-related workers in the five-county area.[8] The area has nearly 140,000 engineers, according to the 1990 Census and Bureau of Economic Analysis.

However, a large percentage of the labor pool is employed in core defense industries.[9] In the five-county region, core defense employment represented half of high-technology employment in 1991; in Los Angeles county it represented 62 percent of high-tech employment. This can be compared to aggregate U.S. figures, where core defense employment represented just 26 percent of 1991 high-tech employment. (County Business Patterns: EDC Analysis)

The area has the technological backbone for this skilled labor force. About 7,000 firms were in these technology-oriented fields, as shown in

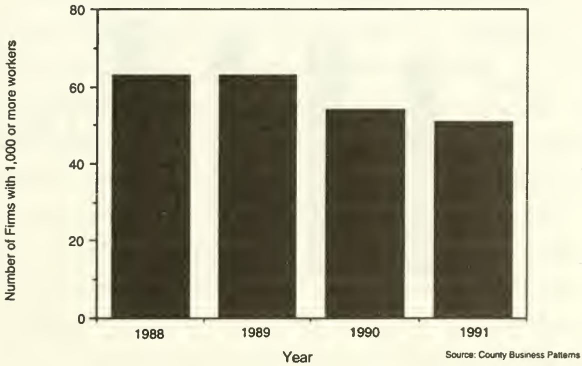
Figure 16. Technology Firms



[8]The source for this and other data is County Business Patterns, whose last figures were released in 1991. Although the state Employment Development Department tabulates more recent data, it relies on surveys, while county business patterns represents more accurate census data.
[9]Defined by the following SIC codes: 372 (Aircraft), 376 (Guided Missiles), and 381 (Search and Navigation).

Figure 16. Figure 17 reveals that the number of large firms with more than 1,000 employees is declining. Although this trend shows a declining reliance on large defense firms, the Economic Roundtable's Defense Reduction Strategy Report in 1993 showed that defense spending represented 51.2 - 65.1 percent of all high-tech industrial sales. (Economic Roundtable: 76)

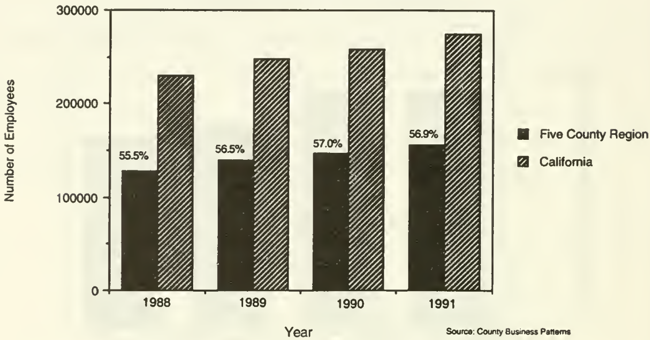
Figure 17. Large Technology Firms



Nearly 190 colleges and universities are present in the region, including four of the nation's top engineering schools: The California Institute of Technology, University of Southern California, University of California at Los Angeles, and Harvey Mudd College, as ranked by U.S. News and Reports. According to the National Science Foundation, more than 24,000 students are enrolled in technology fields — 40 percent of the state's total. Though total R&D figures are difficult to determine, the region's universities spent more than $694 million in R&D in fiscal year 1992. By comparison, the Bay Area universities — primarily a cluster comprising Stanford, UCSF and UC Berkeley — spent $890 million.

Besides a vibrant economy, the thirteenth largest in the world, the area has a host of business services to provide the infrastructure for technological growth. As shown in Figure 18, consistently more than half of the state's lawyers, accountants and management consultants work in the Los Angeles region.

Figure 18. Business Support Services



GAPS IN THE REGION'S SOCIAL STRUCTURE OF INNOVATION

The region has most of the components necessary to further technological growth, but questions remain about the defense workforce's flexibility, and whether a negative reputation discourages deals. Over time the region needs to develop an infrastructure of capital and entrepreneurs.

The national flows of venture capital appear to show it is generally effective in identifying market opportunities. So capital gaps, as Florida and Smith write, are a "function of an area's underlying inability to generate high-technology firms, or more fundamentally, to establish the social structure of

innovation from which high-technology development stems." (Florida and Smith(iii): 358)

In this "social structure of innovation" model, the region lacks key elements — but they can be corrected. The area's large geography — bigger than 41 states — makes industrial networks difficult to form. From Japan's kereitsu groups to Northern Italy's textiles, these industrial networks are fundamental in propelling industrial and technological growth. These networks can advance processes, facilitate shared services and equipment, and establish supplier chains. Spread over a large geographic area that impedes mobility and accessibility, networking is difficult for the area's technological firms. Lee Petillon, an attorney who has worked in venture capital for 30 years, said Northern California firms reported they preferred investing in the Bay Area because "within a small circumscribed area, you have all the expertise and skills necessary for high-tech start-ups. You have the same skills in southern California, but they are spread out over hundreds of square miles."

Efforts, however, are being made to tighten the bonds among regional technology firms. This summer, the High Technology Council, working with the University of Southern California, launched the Information Technology Consortium to merge the communications, software, and creative talents of the region. Similarly, the regional state-funded technology program, the Los Angeles Regional Technology Alliance is working toward developing consortia in environmental technology.

Flexible Workforce and Defense Employment

Though skilled, many have doubted the flexibility and entrepreneurship of the region's technology labor force, nurtured in the

government-dependent defense industries. "It's hard to get people to provide adequate leadership; they [defense workers] are not trained that way and they don't think about products and markets. They think about custom solutions and custom problems," said Jim Cole of Spectra Enterprise Associates.

Spectra Enterprise Associates' strategy in the 1980s focused on entrepreneurs originating from the aerospace industries, the people "who grew up in Hughes, Westinghouse, Rockwell," Cole said. Spectra provided venture capital to these entrepreneurial engineers who formed their own companies servicing both government and commercial clients.

Cole said there were two major problems: first, coinvestment was difficult as many venture capital investors avoided defense-related products. As an example, the 1993 National Census of Seed Capital funds reported that less than one-seventh of venture firms surveyed preferred defense/space technologies. (Meyer: 16)

Second, he said the company management often had problems; the venture capital investors had to provide strategic direction and marketing assistance. "In the case of all the companies we invested in, we wrote a lot of the business plans," Cole said.

Jon Kutler's firm, Quarterdeck Investment Partners, invests in defense technologies applied to commercial ventures. Most venture capital firms avoid defense firms because they "don't know the defense industry; they just don't know where to look for the deals." Even so, Kutler acknowledges the firms take time to incorporate a market perspective; in searching for capital, the firms are "trying to ask for it in the same way they ask for money from Washington. It's the same ball game, but a different language."

Though El Dorado does not usually invest in aerospace companies, general partner Brent Rider said the region lacks a "management cadre" that can bring an entrepreneurial product to market.

"You take a southern California aerospace guy and a northern California software guy, they're both deficient in business skills. The thing that's missing here is a 10-deep cadre of people who started companies," Rider said. "A bright successful entrepreneur who understands technology-based things finds three bright young engineers, who work 24 hours a day to produce a product. You don't have that management cadre here."

Tarnished Reputation

The five county region suffers from the negative perception that the deals are not here. Lee Petillon said he asked a partner at a leading northern California venture capital firm, "How come you guys are so prejudiced against the people in southern California?" "We're not prejudiced," the partner responded. "We'll make investments in southern California. We'll make investments anywhere." Petillon said, "How many investments does your fund have in southern California?" The reply: none.

The northern California partner noted that southern California has resources — but spread out over a wide area. Nevertheless, some news media seem to trumpet the perception that Los Angeles is not the place to do business. For example, as part of a June, 1994 cover story on the "new economy," *Fortune* determined that the region's dominant growth industries were entertainment and tourism, even though the same magazine two months later highlighted six regional firms — in biotech, software and medical/health care — in the nation's top 100 fastest growing companies. "The perception is the film industry and aerospace," said Jon Goodman,

director of the University of Southern California's Entrepreneur Program. "More than anything else people need information about what is here."

The region's negative perception is shared by some venture capital investors in the area. A few of the venture capital investors interviewed were pessimistic about the prospects for venture investments in the region. James Matzdorff of James Matzdorff and Company blamed the real estate downturn and the earthquake for diminished investment opportunity across all sectors. "It's dead," he said. "We're based in LA but we're not doing anything with LA companies. It's been dead for the past two years."

The majority, however, were cautiously optimistic about the prospect for deals in southern California, as noted earlier, in such areas as information technology, medical/health care, and biotech. Often the venture capital investors pointed to the size of the region's economy, its academic institutions, and its position in international trade.

"Being out here in the trenches, we are seeing opportunities of new companies started by entrepreneurial groups," said Chuck Martin of New Enterprise Partners, which focuses on health care and information technology companies. As an indication of the area's potential, Martin said New Enterprise Partners raised a new $112 million fund in eight days. The massive fund was raised almost entirely from institutions, from the foundations of Princeton and Harvard universities, to corporate pension funds of AT&T, Eastman Kodak and GM. "It's incredible testimony to what investors across the country see."

In light of the area's tremendous technological and economic base, the lack of venture capital — and thus venture capital networks — is puzzling.

"The technology is certainly here," said Ed Tuck of Kinship Partners and the Boundary Fund. "It's a problem of culture."

Indeed, many venture capital investors said the area lacks the entrepreneurial drive and the venture capital critical mass. "I think it will take a while because Southern California does not have an infrastructure of capital and doesn't have an infrastructure to teach people how to be good CEOs," said Jim Cole, of Spectra Enterprise Associates.

The next section will explore how to build this infrastructure in a region that has long been identified with a vertically integrated, defense-dependent economy.

SECTION V: POLICY MEASURES

NATIONAL ACTION

A capital gains tax cut should increase venture investment.

Venture capital supply will increase if equity investing becomes more profitable. A lower capital gains tax, therefore, should increase the venture capital supply. For example, in 1978, the capital gains tax was reduced from 49 to 28 percent. In the following six years, venture capital supply increased immensely; $13.2 billion was committed to venture capital, more than 28 times the capital raised in the previous eight years (Doerflinger and Rivkin: p. 45).[10]

Long-term investment, as well as increased investment, can be encouraged by reducing the capital gains tax as the holding period in the firm increases. For example, the 1993 federal tax bill excluded 50 percent of the capital gains tax for holdings in small companies greater than five years. To

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[10] During the same period, the U.S. Department of Labor permitted pension funds to invest more in venture capital partnerships, also contributing to the supply increase.

increase early stage investment, individuals could be permitted to write off direct investments in new companies. The tax deduction could be recaptured if investors sold their investments before five years of holdings.

LOCAL ACTION

"There is not what I consider a venture capital industry here," said one investor. Programs that teach entrepreneurs business skills, form venture capital networks, increase exchanges between venture investors and entrepreneurs will encourage technology enterprises. Complemented by these programs, a private/public fund can draw other investors.

Across the nation, researchers have found that venture capital is a fairly efficient market: "regional capital gaps exist because there are too few deals to attract venture capital, not because capital markets are inherently biased and inefficient." (Florida and Smith: 66)

Nevertheless, two factors call for action at the local level. First, the characteristics of lead venture capital investors — the network of contacts, the hands-on assistance given to companies — often leads them to invest locally. As Chuck Martin of Enterprise Partners said, "it isn't very efficient to come in with a briefcase in the morning and build a relationship."

More importantly, the area has a tremendous potential to develop technology-related entrepreneurial ventures. As shown earlier, the five county region has many of the pieces required to fire technology-based ventures — the raw technological talent combined with a massive economy and infrastructure. Although much of the current technology-base is defense related, the defense drawdown may enable nascent entrepreneurs to take the startup venture plunge. Or, the down-sizing can lead to opportunity for these firms, as they produce such commercial products as satellites and

communications equipment. Finally, a new generation of technologists, sprouted from CalTech, UCLA, USC and other schools, can be trained for the region's new industries in environmental technology, biomed, and software.

Local organizations can develop this potential by increasing training of entrepreneurs, establishing networks of venture capital, and connecting venture capital sources with entrepreneurs.

Entrepreneurial Assistance Programs

A number of business assistance programs exist in the five county area. While many do not provide aspiring entrepreneurs with the language to access equity financing, a few programs do walk entrepreneurs through the process.

Some of these programs, shown in Table 3, provide entrepreneurs with hands-on training to launch their ventures. In many of these programs, entrepreneurs can receive advice on their business plan, product development, production, marketing, executive staffing and financial issues. Essentially, technologists can learn to "speak the language" of venture capital investors and more importantly, develop the skills that will make their venture profitable.

By teaching technologists basic business skills, high-technology ventures can profit. For example, physicist Albert Capote had developed conductive ink for electronic circuit boards, eliminating the use of toxic materials and the production of waste water, but needed a business understanding to market the technology. At UCLA's entrepreneurial program, Capote developed the skills to write a business plan, analyze the market and speak to venture capital firms. (Daily: 9)

Table 3. University-based Entrepreneurial Programs

University	Program
California Institute of Technology	Enterprise Forum
University of California, Los Angeles	Entrepreneurial Studies Center
University of California, Irvine	ACCELERATE
University of Southern California	FastTrac Entrepreneurial Training

The Product Development Partnership (PDP) at the Economic Development Corporation is also designed to propel high-tech ventures. This program provides

- information on local agencies that can provide hands-on assistance;
- technical consulting assistance on a pro-bono or subsidized basis covering services ranging from financial control to implementing accounting records/systems; and
- low-cost revolving loan fund.

Since 1993, the PDP has committed $190,000 in technical assistance awards and $730,000 in low-cost loans. It has assisted 250 companies, representing 20,000 jobs.

Venture Capital Network Development

Many venture capital investors interviewed complained about the lack of networks in southern California. In other regions, these networks enable venture capital investors to syndicate to reduce risk. (Don Smith: interview) These networks also allow investors to "pass" potential deals, increasing the odds that a venture will be funded.

Few venture capital networks exist in southern California, in part because the region is so large and no venture capital center exists. Venture

capital firms' locations range from Westlake Village in the north to Costa Mesa in the south to West Covina in the east. "I can't get up at 4 a.m. to go to the Orange County Venture Association meeting," said Ed Tuck of Kinship partners, whose office is in the Inland Empire.

In fact, the Orange County Venture Network is one of the few regular networking opportunities for venture investors. The network sponsors monthly speaker breakfasts and runs an electronic bulletin board for accessing resources in the network's Orange County Venture Guide. In Los Angeles, the Los Angeles Venture Association this spring sponsored an investment capital conference, featuring investment bankers, advice for financing growth companies and strategic partnering.

This networking paucity can be contrasted with the Bay Area, with its dense venture capital network, concentrated on Sand Hill road. As one venture capital investor said, "there is not what I consider a venture capital industry here."

Linking Entrepreneurs with Investors

Especially at the informal "angel" investor level, information gaps can prevent promising ventures from receiving funding: "neither the full information nor the low transaction cost criteria is fulfilled in the invisible angel venture capital market." (Freear, Sohl, Wetzel(i): 8) Because angels are invisible — there is no Pratt's guide to Angel Investors — and entrepreneurs cannot broadcast their needs, worthy ventures may go unfunded. Similarly, although entrepreneurs may contact established venture capital firms, blind business plans are rarely funded. Both entrepreneurs and investors — and the region's technology base — lose when promising matches are not made.

But venture funding can increase simply by maximizing the information flow between investors and entrepreneurs. Programs that match investors and entrepreneurs in a database — with their required specifications — can forge deals, expanding opportunities for both parties.

Within the past four years, two new programs have sought to link investors' wishes with entrepreneurs' ideas. At the newer program, the Los Angeles Venture Network, entrepreneurs seeking $50,000 to $500,000 equity financing are entered into a databank. High income investors are also entered into the database. Investor requirements, in terms of technology, financing amount and geography, are compared with a brief summary of the entrepreneur's business plan, which is screened by graduate business students at the University of Southern California. So far, 40 business plans have been submitted and five investors have signed up. In Orange County, Pacific Venture Capital Network (PACNET), part of the University of California Irvine's ACCELERATE program, also matches entrepreneurs with investors. To date PACNET has helped raise $3.5 million in venture capital funding.

These services are based on similar programs in Texas and in Massachusetts. The first program, the Venture Capital Network in Massachusetts, was founded in 1984 and in the next six years served 1,200 entrepreneur clients and about 800 investors (about one-fifth were venture capital firms) (Freear, Sohl and Wetzel: 13). The typical entrepreneur met four to five potential investors. Though SEC regulations prevented VCN from publishing a detailed evaluation of match-up results, sponsors of VCN learned that 3,500 introductions were arranged to more than 900 entrepreneurs and more than 300 investors. Jeff Sohl, at the Center for Venture Research that helped launch the VCN (now called Technology Capital Network), said 30 percent of the proposals are funded.

At the Economic Development Corporation of Los Angeles County, venture capital investors, lawyers, accountants and economic development officials are planning a venture capital forum in March, 1995 that would highlight the top entrepreneurs to venture capital firms nationwide. Prior to the forum, a evaluation panel would solicit business plans, rank the top candidates, and then work with the top entrepreneurs on their proposal. At the Forum, the top selected entrepreneurs could present their plans, while those entrepreneurs who submitted proposals could have their businesses exhibited in a poster fair. Just like PACNET and the Los Angeles Venture Network, the forum will provide one-stop shopping for investors, while increasing networking opportunities for venture capital investors. Entrepreneurs, of course, could significantly improve their chances of finding funds.

Venture Capital Seed Fund

Typically, entrepreneurs complain about the lack of funds: "We started out with our savings, essentially," said Ann Fay, president of PHI Applied Physical Sciences. "We have somebody who is looking for private capital. But the problem is we don't know very many people."

Typically, venture capital investors say plenty of capital is available for promising ventures. "There's an ample amount of capital to be invested here," said James Bergman of DSV Partners.

However, many venture capital firms disagreed, saying a dearth of capital, especially early stage money, exists in southern California. "Clearly, there is a shortage of capital," said Chuck Martin of Enterprise Partners. "This is a very underserved market by the venture capital community."

Simply supplying the five county region with more venture capital will not automatically increase the number of deals regionally. However, combined with other policies discussed previously, a public/private fund could send a positive signal to venture firms that deals are here. Though RAND researcher Don Smith found that capital flowed freely across geographic barriers, he acknowledged that geography, and reputation, played a role. "There is some nature of the herd mentality" to venture capital, he said. "If there is perceived an area that is a good investment, people will look harder, see and perhaps review the investment."

"A lot of it is thinking of potential deals as being a signal that there's an investment opportunity," Smith said. "Having had an investment, you increase the opportunity that a signal will be received."

A public/private fund that supplements private investors, therefore, can draw in new investors, showing them that deals are here. "You leverage southern California to make it a magnet," said Jon Goodman, Director of USC's Entrepreneur Program, which operates the LA Venture Network.

Throughout the country, public-sponsored funds attempt to put their regions "on the map" by leveraging public dollars in a variety of forms. However, a public-sponsored fund must be carefully designed. They must work with entrepreneurial and network-building programs because public capital, on its own, cannot advance a region's technology or economy — public venture capital is tiny. In 1989, for example, $2.5 billion was invested by private venture capital investors, while state programs invested just $54 million. (Eisinger: 68)

In general, public venture capital programs can be divided into two tacks. A pension fund set aside program dedicates a portion of public employee pension funds to a venture investment often managed by a private

firm. At least 21 states have public employee pension fund venture capital programs. Some set up a single fund, composed of pension moneys, that invests in companies. Other states, like Maryland, set up a fund of funds that invests $19 million in pension funds in other venture capital funds. (Sackman: 29). Here in southern California, one venture firm received its entire $75 million portfolio from CALSTRS, the teachers retirement fund. Resources do exist locally that are not used. For example, the city of Los Angeles' three separate pension funds that total approximately $13 billion do not dedicate any portion to venture capital investment. On the other hand, the Los Angeles County Employee Retirement Association dedicates approximately .6 percent of its $14 billion to venture investments; it aims to increase its venture investments to 1 percent of the fund.

The second tack is a state fund. In this approach, public funds — from lottery proceeds, tax revenues or bond sales — are invested in businesses directly, or through a private intermediary. These funds can provide grants to develop products, such as the Economic Development Corporation's Product Development Partnership. Or, state funds can supplement Business Development programs that provide working capital for businesses; the funding organization could receive royalties if the business is profitable. In a survey of state venture capital programs, Peter Eisenger reports that 18 states maintained business development programs.

The structure of these programs varies. For example, a state loan program is a special limited partner in a private venture capital fund, the Connecticut Seed Partners, that makes equity investments of $50,000 to $1 million. In Michigan, the state loaned $8 million to establish four in-state seed capital companies; the loans were matched by private companies and then invested as equity in targeted businesses. (Eisinger: p. 68) Similarly, in

Pennsylvania, the Ben Franklin Seed Venture Capital Fund uses $4.5 million in state funds to establish five privately managed seed capital funds; the state receives royalties from the seed fund awards if the venture is profitable.

One of the oldest funds, the Massachusetts' Technology Development Corporation, has not received state allocations since 1988; it has recycled earnings from past investments. The program was established in 1978, capitalized with $3 million in federal grants to establish revolving loan funds and state appropriations ranging from $500,000 to $1 million per year to make equity investments, generally between $100,000 and $250,000. An evaluation of the program found that its investments earned $6.1 million, offsetting the $4.3 million operating costs. Up until June 1986, the program's $7.4 million first round investment leveraged $38 million in private capital coinvestment. (Fisher: 170) As the program's evaluator noted, "MTDC's experience clearly demonstrates that the public sector can operate a venture capital fund that is successful in private sector terms." (Fisher: 172)

In a survey of 67 seed funds nationwide, Emory Business School found that public funds invested 75 percent of their money in early stages, while private funds make 43 percent of their investments in those stages. However, the report found that private funds nurtured the companies they invested in, providing follow-on capital and working assistance, while only 20 percent of public funds provided subsequent financing for invested companies. Public funds, whose charters often include economic development and job goals, had the lowest return on investment, at just 6 percent; their failure rates were the highest at 20 percent. (Meyer: 13) Table 4 shows that combination funds outperformed both private and public funds.

Table 4. Performance of Seed Funds.

Fund Type	Return on Investment	Failure Rate
Combination	23	12
Private	18.8	16
Public	6	20

Source: The 1993 National Census of Seed Capital Funds. p. 13

As indicated earlier, poorly designed public funds can be dangerous. They may invest in unprofitable ventures if they are restricted to a certain geographical area. Or, the funds will flow to areas where deals already appear to exist, such as Silicon Valley. Finally, as the seed fund survey indicates the public funds must provide the technical assistance and "hands-on" approach, present in most private venture firms, that reduce risk and help birth new businesses.

Current Efforts to Establish a Public/Private Fund

In the South Bay, a venture capital investor and a technology transfer consulting firm are working to form a small business investment corporation (SBIC), the California Technology Fund, that will focus on southern California early stage ventures. As an SBIC, the California Technology Fund could leverage privately raised capital by a factor of up to three or four from the federal government. (Kleiman, Shulman: 198) Recent legislation amending SBIC rules, allows SBICs to invest in companies with a net worth of less than $18 million, increasing SBICs' flexibility (VC Journal June 1994: 39).

Fred Haney, who has worked in corporate development and venture capital for 26 years, initially sought to establish the technology fund from a large pension fund. However, he said that the "gatekeepers" of pension

funds — which supply the bulk of venture capital nationwide — do not risk investments on new venture capital firms, relying on existing firms raising new funds. Haney said it is "impossible to raise funds from conventional sources of venture capital.

"Even with experienced partners, they want a six or seven year minimum, a good track record and a 20 percent internal rate of return," Haney said. "So I haven't wanted to waste my time to keep banging my head against the wall."

However, a representative of one large California pension fund, which allocates five to seven percent of its $45 billion fund to venture capital, said that venture capital firms may "feel like they're not getting an even shake, but they are treated more fairly today than their predecessors." Prior to the Department of Labor ruling that pension funds could expand their investments in venture capital, venture capital investors could not look to one source to supply a large portion of their funds. Now, he said, they have greater options.

Nevertheless, discouraged from seeking funds from pension funds, Haney is establishing an SBIC, working with the Los Angeles technology transfer consulting firm of Montgomery & Associates and the South Bay Jobs Task Force, which is attempting to build a science park in the South Bay in Los Angeles.

The California Technology Fund would target early to middle stage ventures and focus on the region's burgeoning technologies: information technology, computers, medical devices, and biotechnology. The fund would focus on providing management assistance for the ventures, as well as seek non-venture capital funding. Haney said the fund would also be designed to

work with economic development and entrepreneurial groups such as ACCELERATE at UCI and the Jet Propulsion Lab.

SECTION VI: FURTHER RESEARCH

This paper focused on the status of venture capital in southern California, while providing an overview to measures currently underway. The following topics should be researched further.

1. Conduct an in-depth assessment of entrepreneurial assistance programs. Determine specific policy measures to enhance their visibility/use. Examine the number of defense-related clients served.
2. Examine measures to set up in Los Angeles the equivalent of the Orange County Venture Network.
3. Assess the progress of "matching" programs, such as the LA Venture Network, and recommend measures to increase their participation.

SECTION VII: CONCLUSION

Southern California's technological boom was powered by non-commercial defense spending. Yet as the defense drawdown slashes the area's technological employment, venture capital is currently not available to provide the fuel for entrepreneurs to branch out on new ventures. According to most measures, 1993 was the worst year for southern California venture capital.

1. Venture firms invested in half as many regional companies as a decade ago; they made slightly more than a third of number of 1983 investments.
2. The number of seed and startup companies receiving funds has decreased by 50 percent from 1983 levels.

3. By far, the majority of California firms receiving venture capital were located in the Bay Area. Less than 20 percent of California companies receiving venture capital were located in the five counties.
4. There are less than 35 active venture capital firms with capital under management in the five county region.
5. There are few networking opportunities for venture capital investors in the five county region. Because the region is so large — and the technology areas so broad — interaction between venture capital firms and entrepreneurs is limited.

The strength of the aerospace/defense sector most likely deterred venture capital investments. However, other deterrents exist: the area's large geography impede the investor-entrepreneur interaction possible in the Bay Area. The region's negative reputation, as no place for deals, also impedes this investment.

Nevertheless, the educational facilities, the raw technological talent, the economic infrastructure, and the business services represent enormous potential for the region. These raw building blocks provide a solid foundation to grow and convert the region's technological base. Primarily, the region lacks venture capital, which could be attracted by networks of venture capital investors and that elusive entrepreneurial "culture."

A region's culture, and mindset, cannot be changed spontaneously. Yet for the region to transform into a dynamic technological juggernaut, it will need venture capital. For the venture capital investors to invest, they will need to see deals.

Policies that increase information exchange, set up venture capital networks, help entrepreneurs develop their business skills, and act as draws for venture capital investments may not transform the region's culture —

both entrepreneurial and venture capital — overnight. But they may catalyze the nascent entrepreneurial fire, or open players' eyes to what is already emerging.

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